Supreme Court, U.S.
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No.

In the

Supreme Court of the United States

ESTATE OF JOSEPHINE T. THOMPSON, Deceased, CARL T. HOLST-KNUDSEN and THE BANK OF NEW YORK, Executors,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

JAMES F. RITTINGER
Counsel of Record
ROBERT H. GOLDIE
JOSHUA M. RUBINS
KIRK H. O'FERRALL
SATTERLEE STEPHENS
BURKE & BURKE LLP
230 Park Avenue
New York, New York 10169
(212) 818-9200

Attorneys for Petitioner

QUESTION PRESENTED

In 1998, responding to the concern that individual and small business taxpayers are often at a disadvantage in litigation with the Internal Revenue Service ("IRS"), Congress enacted the Internal Revenue Service Restructuring and Reform Act, also known as the "Taxpayer Bill of Rights." Section 7491 of the Act provides that the burden of proof on any fact-driven issue will shift to the IRS Commissioner if a taxpayer produces all relevant documentation, cooperates with inquiries by the IRS, and presents "credible evidence," which has been uniformly defined as evidence sufficient to establish the basis for a decision in the taxpayer's favor, subject only to the introduction of contrary evidence by the Commissioner.

In this case, although the taxpayer met the standard for shifting the burden, and the Commissioner, whose only evidentiary submission was held to be worthless, indisputably failed to prove his case, the Tax Court failed to find in the taxpayer's favor. The Second Circuit Court of Appeals, interpreting the statute in a manner that conflicts with decisions of other Circuit Courts, affirmed the Tax Court's ruling.

The question presented is:

Whether a taxpayer who has met all criteria for shifting the burden of proof under IRC § 7491 is entitled to judgment in its favor when the Commissioner fails to prove his case and his only evidentiary submission is rejected by the Tax Court.

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PETITION FOR A WRIT OF CERTIORARI

Estate of Josephine T. Thompson, Deceased, Carl T. Holst-Knudsen and The Bank of New York, Executors, respectfully petitions that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit entered on August 23, 2007.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit, 499 F.3d 129, is dated August 23, 2007. (App. A-1) The opinion of Judge Swift of the Tax Court, 2004 WL 1658404, is dated July 26, 2004. (App. A-17)

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on August 23, 2007. A Petition for Rehearing and Petition for Rehearing En Banc was timely filed, and was denied on November 14, 2007. (App. A-81) Pursuant to Supreme Court Rule 13, this petition has been filed within 90 days of the denial of rehearing.

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). The jurisdiction of the Court of Appeals was invoked pursuant to 26 U.S.C. §§ 7482(a) and 7483. The jurisdiction of the Tax Court was invoked under 26 U.S.C. §§ 6213 and 7442 and Tax Court Rule 13(a).

STATUTORY PROVISION INVOLVED

This petition involves the interpretation and application of Section 7491 of the Internal Revenue Code, 26 U.S.C. § 7491 (herein, "Section 7491"), enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998, which provides, in subsection (a), that, as a general rule, "[i]f, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue." IRC § 7491(a)(1). (App. A-83)

The provision limits application of this general rule to cases in which the taxpayer, in addition to meeting the "credible evidence" requirement, has also: (i) "complied with the requirements under this title to substantiate any item"; and (ii) "maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews." IRC § 7491(a)(2). (App. A-83)

STATEMENT OF THE CASE

This case involves the valuation of the late Josephine T. Thompson's minority interest in Thomas Publishing Company ("TPC"), a closely-held, family-owned publisher of directories founded in the late 19th century by Mrs. Thompson's father. Mrs. Thompson died on May 2, 1998, and included in her estate (the "Estate") were 487,440 shares — approximately 20.5% — of the stock of TPC.

In 2002 the Estate petitioned the Tax Court, challenging a determination by the Commissioner of Internal Revenue (the "Commissioner") that the Estate had undervalued the TPC stock on its federal estate tax return. The Commissioner's deficiency notice valued the TPC stock at $72.36 per share (as of May 2, 1998) and assessed a tax deficiency of $17,910,408.26 and imposed additions to tax of $7,164,163.30.

At trial the Estate offered the reports and testimony of valuation experts that the TPC stock was properly valued at $3.59 per share, using the capitalization of income method. This valuation took into consideration such factors as TPC's declining profitability, the industry outlook in the 1990s for traditional print-directory publishers, and TPC's failed attempts and ongoing efforts — at huge expense — to try to adjust to the digital information revolution, including the meteoric rise of the Internet. In further support of this valuation analysis, the Estate submitted, *inter alia*: the testimony of TPC's President and two experts on investing in the directory-publishing industry; financial records reflecting TPC's struggle to survive (with nearly $14 million in losses by 2001); extensive internal TPC documentation — prior to May 1998 — regarding management's fears that the company was at grave risk; and scholarly articles on the paradigm shift in publishing that by 1998 had already destroyed several venerable reference-book publishers.

In response to the Estate's request, the Tax Court ruled that the Estate, through its experts' report and other evidentiary submissions, had introduced credible evidence in support of its valuation as

required by Section 7491. This ruling was later confirmed by the Tax Court in a footnote in its opinion: "At trial, we determined that for purposes of sec. 7491(a)(1), the evidence produced by the estate as to the valuation of the TPC stock was to be treated as credible evidence." (App. A-46) As discussed further below, although Section 7491 does not define what constitutes credible evidence, the courts have consistently adopted the definition set forth in the conference reports preceding enactment of the statute: "Credible evidence is the quality of evidence which, *after critical analysis*, the court would find *sufficient upon which to base a decision on the issue* if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)." H. Conf. Report. 105-5999, at 240-241 (1998) (emphasis added).

It was undisputed that the Estate also met the additional requirements of IRC § 7491(a)(2). Accordingly, the Tax Court recognized that the Commissioner, not the Estate, "has the burden of proof with regard to the valuation of the estate's 20-percent stock interest in TPC." (App. A-46)

The Tax Court's proper application of Section 7491 ended there, however. Indeed, in its July 2004 Memorandum Findings and Fact and Opinion, the Tax Court treated the statute as a nullity, making no reference at all to the burden of proof — except in the footnote quoted above, which merely confirmed its ruling at trial. Certainly the Tax Court made no finding that the Commissioner, as required by the statute, had met its burden of proof on the valuation issue. On the contrary, the Tax Court emphatically rejected the Commissioner's only proffered evidence — the appraisal opinion of a valuation expert — as

worthless in every respect, finding that the expert had not only used the wrong methodologies but had made no attempt at all to understand the nature or operation of TPC's business. (App. A-71-73) The Tax Court concluded that the Commissioner's expert had adopted a "sterile approach" and "did not appear to make an effort to base his valuation of TPC on a real company." (App. A-71). The Tax Court also noted that there were "significant errors" in this analysis and that the Commissioner's changing calculations involved "significant questionable adjustments" that were "suspect, not sufficiently explained, and not persuasive." (App. A-46, A-54, A-73).

Moreover, the Commissioner submitted no evidence at all on the key factual issue underlying the valuation of TPC's stock: the impact of the digital information and Internet revolutions on TPC's prospects as of May 1998. The Estate's experts concluded that any reasonable buyer in May 1998 would have understood that TPC was facing a serious downturn due to these cataclysmic changes — and that the purchase price of any TPC stock would have reflected this. This conclusion was supported not only by internal TPC documents, industry studies, and the testimony of industry experts and TPC's management, but also by an economics expert, Kenneth Lehn, former chief economist for the Securities and Exchange Commission, who testified as to the significance of TPC's plummeting operating margins and negative growth rate between 1994 and 1997. Indeed, TPC's financial records for the 1998-2002 period (showing a 90% decline in income, a growth rate of *negative*

44%, and huge losses) confirmed that the company's grim early forecasts were, if anything, not grim enough.[1] (App. A-36)

The Commissioner's valuation, rejected in toto by the Tax Court, took none of this into account. The Commissioner submitted no fact witnesses, no industry experts, and no industry studies to support his position — or contradict the Estate's position — on the impact of the Internet.

Nonetheless, despite the Commissioner's patent failure to meet his burden of proof, the Tax Court did not enter judgment for the Estate, as required by the statute. Instead, the Tax Court made its own valuation, calculating the value of the TPC stock at $27.75 per share. The Tax Court adopted the methodology and certain findings of the Estate's experts but altered two critical calculations, increasing the valuation of the TPC stock by over $10 million, based on the Court's startling conclusion that "the Internet, as of May 2, 1998, constituted a factor for TPC almost as positive as it was negative." (App. A-73-74)

The Tax Court referred to no evidence submitted by the Commissioner in making this finding with regard to the impact of the digital information revolution on TPC's prospects. The Commissioner's sole witness — his expert, whose valuation was deemed worthless by the Tax Court — claimed no expertise with respect to either the relevant industry or the Internet. In fact, to the limited extent that the

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[1] As the Tax Court acknowledged, post-death facts such as these are properly considered in the valuation analysis. (App. A-44-45) (citing cases).

Tax Court referred to the record in reaching its conclusion that TPC faced no serious threat from the Internet, it referred to the same body of evidence — the testimony of TPC's President, the report and testimony of the Estate's experts, TPC's financials and internal documents — that the Tax Court previously found to constitute a credible evidentiary showing sufficient to support a finding that the Estate had proven its valuation.[2]

In accordance with the Tax Court's opinion, a Decision of the Tax Court was entered on November 3, 2005, finding a deficiency in the estate tax due from the Estate in the amount of $3,397,255.91. The Decision also reflected the Tax Court's finding that, under the "reasonable cause" exception (IRC § 6664) to the penalties to be imposed under IRC § 6662, the Estate owed no penalty. (App. A-15)

Subsequently, the Estate filed a timely appeal to the United States Court of Appeals for the Second Circuit challenging the Tax Court's decision on the ground, *inter alia*, that the Tax Court had failed to apply Section 7491 by not holding the Commissioner to his burden of proof. Indeed, given the meaning of "credible evidence" for purposes of Section 7491, the Tax Court's decision was, on its face, in conflict with the statute. Having found the Estate's case sufficient to support a finding in its favor if no contrary evidence were submitted by the Commissioner, the

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[2] In an apparent attempt to justify its failure to apply IRC § 7491(a), the Tax Court stated in its opinion that the Estate's valuation experts, previously deemed "credible," were actually, in the Tax Court's view, only "marginally credible." (App. A-66)

Tax Court then threw out the only evidence submitted by the Commissioner — yet failed to make a finding in favor of the Estate.

On appeal, the Second Circuit affirmed the Tax Court's rulings as to valuation (except for one relatively minor error in calculation). The Second Circuit acknowledged that, under Section 7491, the Estate's evidentiary showing had shifted the burden of proof on the issue of valuation to the Commissioner.[3] (App. A-6) The Second Circuit did not deny that the Commissioner had failed to prove his case and, indeed, was excoriated by the Tax Court for the patent inadequacy and suspect nature of his expert's valuation. Nor did the appellate court deny that the Commissioner had failed to submit any evidence, other than the discredited opinion of his expert, either to support his own case or to contradict that of the Estate.

Notwithstanding this record, the Second Circuit held that the Tax Court was free to reject the Estate's "credible" valuation and substitute a valuation of its own devising. (App. A-7) The appellate court did not expressly find that the Commissioner had met his burden nor did it explain why the Commissioner did not need to prove his case in accordance with traditional burden-of-proof principles. Instead, the Second Circuit decision suggested that the Commissioner's burden of proof

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[3] The Second Circuit's decision erroneously stated that "the parties stipulated" to the Estate having met the threshold of having made a "credible" evidentiary showing. (App. A-7) In fact, the Commissioner refused to stipulate to the credible evidence threshold, forcing the Tax Court to rule on this issue in favor of the Estate. (App. A-46)

under Section 7491 can be satisfied merely by offering arguments against the taxpayer's case and by citing "evidence in the record that impeaches, undermines, or indicates error" in the taxpayer's calculation. The Second Circuit did not identify what record evidence supported the Commissioner's arguments, stating that "the Tax Court adopted some of the Commissioner's arguments in opposition to the Estate's valuation. . . ."[4] Moreover, the Second Circuit indicated that its finding might have been the same even if the Tax Court had rejected all arguments advanced by the Commissioner in opposition to the Estate's valuation, "or if the Commissioner had made no such arguments." (App. A-7 n.2)

In affirming the Tax Court's decision, the Second Circuit further stated that, in a valuation case, the reallocation of the burden of proof under Section 7491 does not require the Tax Court to adopt the taxpayer's valuation, "however erroneous," when the Tax Court rejects all aspects of the Commissioner's valuation. (App. A-7) However, the Second Circuit failed to recognize that the burden of proof would never be shifted to the Commissioner unless the taxpayer's case had already been found, after "critical analysis," to be sufficient to satisfy the credibility and substantiation standards of Section 7491 and to support a finding in the taxpayer's favor.

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[4] Similarly, the appellate decision set forth a conclusion that the Tax Court's valuation was not "clearly erroneous" because there is "evidence to support" its findings but did not identify this evidence. (App. A-8)

The Second Circuit's opinion was issued, and judgment was entered, on August 23, 2007. A Petition for Rehearing and Petition for Rehearing En Banc, timely filed, was denied on November 14, 2007. (App. A-81)[5]

REASONS FOR GRANTING THE PETITION

The application of the statute in this case by both the Second Circuit and the Tax Court renders Section 7491 a virtual nullity, frustrating the legislative intent to level, at least to some degree, the playing-field between taxpayers and the Internal Revenue Service. This case demonstrates that there is disagreement among the Circuit Courts of Appeal, and confusion within the Tax Court, as to the significance of the "burden of proof" in tax cases and the proper application of Section 7491, particularly in valuation cases.

This is an extremely important moment in tax jurisprudence. In enacting Section 7491 Congress changed the landscape of Tax Court adjudication, placing the burden of proof on the Commissioner where the taxpayer has, *inter alia*, made a "credible" evidentiary showing on a fact-driven issue. The legislative mandate is clear: if the taxpayer meets its threshold burdens, the burden shifts to the Commissioner to prove that a contrary finding is

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[5] In its decision, the Second Circuit also found that the Tax Court's findings with respect to the reasonable cause exception under § 6664 were insufficient and remanded for further findings. (App. A-13) That aspect of the decision was not challenged in the Petition for Rehearing and is not at issue on this Petition.

required. All courts, including the Second Circuit in this case, have agreed that Section 7491 applies to the Tax Court's valuation findings.

As detailed below, the courts of several Circuits have held that when Section 7491, or some other rule of law, places the burden of proof in a valuation case on the Commissioner, and the Commissioner fails to prove his valuation by a preponderance of the evidence, the Tax Court, in accordance with essential burden-of-proof principles, must find for the taxpayer. This result is consistent with the Congressional mandate and ensures judicial economy, limiting the number of cases in which the Tax Court is required or empowered to search the record and make its own valuation.

The law of the Second Circuit, however, as set forth in this case, is that the Tax Court may decline to find for the taxpayer, and take on the role of appraiser, no matter how abjectly the Commissioner fails to prove his own valuation — so long as the Tax Court agrees with any argument made against some aspect of the taxpayer's valuation by the Commissioner. Indeed, the Second Circuit has gone even further, suggesting that Section 7491 might not require the Tax Court to find for the taxpayer even if the Commissioner both fails to prove his own case and offers *no arguments* and cites *no evidence at all* in opposition to the taxpayer's valuation. This

interpretation of the burden of proof, which renders Section 7491 meaningless in virtually all valuation cases, appears to be unprecedented.[6]

The Second Circuit's decision not only conflicts with the approach taken in other Circuits but, contrary to the mandate for judicial economy implicit in the statute, it provides a blueprint for an increased burden upon the Tax Court, with myriad valuations created by judges rather than appraisers, and upon the Court of Appeals as well, given the extensive evidentiary issues raised on appeals from judge-made valuations. Moreover, the Second Circuit's decision sends a message, contrary to both the letter and spirit of the statute (a vital component of the "Taxpayer's Bill of Rights"), that, in any income or estate tax case, the Commissioner can submit a baseless valuation many times larger than the taxpayer's and count on the Tax Court to step in and arbitrarily "split the difference" — even when, as here, the taxpayer's valuation has met the requirements that shift the burden of proof to the Commissioner.

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[6] *See* John A. Bogdanski, *From the Editor*, 11 Valuation Strategies 3, 2007 WL 4328637 (November/December 2007), in which the commentator analyzes the Second Circuit's "novel" approach in this case and observes that the appellate court's "explanation of the burden of proof seems to reduce its significance." Contrasting the Second Circuit's analysis with commonly understood burden-of-proof principles, the commentator asks: "Can a taxpayer bear the burden of going forward while the IRS bears the burden of ultimate persuasion under Section 7491? That would seem a revolutionary idea." *Id.*

A. Background of the Statute and the "Credible" Test

Section 7491 was enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. 105-206, 112 Stat. 685, enacted 1998-07-22), also known as the "Taxpayer Bill of Rights." (App. A-83) The Act resulted from the work of the National Commission on the Restructuring of the Internal Revenue Service, popularly known as the Kerry-Portman Commission, and responded to the concern that "individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the Internal Revenue Service." S. Rep. No. 105-174, at 44-46 (1998). Following oversight hearings of the Senate Finance Committee in September, which focused in part on the need for expanded protections for taxpayers, *see, generally, Practices and Procedures of the Internal Revenue Service, Hearings before the Senate Comm. on Finance*, 105th Cong. (1997), initial proposals were made by both House and Senate for a burden-shifting provision.

The provision included in the House version of the Act provided that the burden of proof would shift to the Commissioner when, along with all other requirements, the taxpayer "asserts a reasonable dispute with respect" to any factual issue. H.R. 2676, 105th Cong. § 301 (1997). However, the bill as enacted imposes a far more rigorous threshold for the taxpayer to meet before the benefits of burden-shifting can be obtained. The "credible evidence" test in the final version of Section 7491 has been consistently interpreted to require the taxpayer not merely to demonstrate a "reasonable dispute" but

effectively to establish the basis for a decision in the taxpayer's favor — subject only to the introduction of contrary evidence from the Commissioner.

Courts that have addressed and determined the meaning of "credible" in the context of Section 7491 (as the Second Circuit did not) have referenced and relied upon the definition suggested by the legislative history. The House Conference Report that preceded enactment of the Restructuring Act states:

> Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief.

H. Conf. Report, 105-599, at 240-241 (1998), 1998-3 C.B. 747, 994-995 (emphasis added). *See, e.g., Blodgett v. C.I.R.*, 394 F.3d 1030, 1035 (8th Cir. 2005) (adopting language from House Report to define "credible evidence"); *Thompson v. United States*, 523 F.Supp.2d 1291, 1296-97 (N.D. Ala. 2007) (same). The taxpayer must also demonstrate that it has maintained all records required for purposes of section 7491(a)(2)(B) and has cooperated with reasonable requests from the IRS for witnesses, information, documents, meetings and interviews for purposes of section 7491(a)(2)(B).

Thus, for a taxpayer, meeting this initial burden under Section 7491 is not, as might be inferred from the Second Circuit's opinion, by any means a mechanical, minimalistic, or routine threshold showing. The Tax Court is required to subject the taxpayer's evidence to "critical analysis" and determine that this evidence, standing alone, would support a decision for the taxpayer. Given the nature of the test, it is hardly surprising that, since the enactment of Section 7491, "the cases in which the taxpayer has successfully shifted the burden of proof, absent a concession by the Commissioner, have been few." M. McMahon, Jr. & L. Zelenak, FEDERAL INCOME TAXATION OF INDIVIDUALS, 3d Ed., Warren Gorham & Lamont (2007), ¶51.02. Whether the taxpayer has succeeded in shifting the burden is a serious obstacle for the taxpayer and a frequent matter of dispute.

In *Kohler v. C.I.R.*, T.C. Memo 2006-152, 2006 WL 2059210 (U.S. Tax Ct. July 25, 2006), for example, the Tax Court's weighing of arguments on the hotly contested issue of whether the taxpayer had met the threshold occupies a significant portion of the decision. *Id.* at **6-7. Other decisions, too, highlight the "critical analysis" and skepticism employed by the Tax Courts in restricting the number of cases in which the burden is shifted. The Tax Court is free to reject evidence that is "uncorroborated, although uncontradicted, evidence by interested witnesses." *Estate of Erickson v. C.I.R.*, T.C. Memo 2007-107, 2007 WL 1364407 (U.S. Tax Ct. April 30, 2007), at *6 (finding that taxpayer failed to meet initial IRC § 7491 burden). It will also reject, *inter alia*, "broad, generalized testimony" that lacks sufficient probative value or evidence that "cuts both ways." *Davenport v. C.I.R.*, T.C. Memo 2006-

215, 2006 WL 2845690 (U.S. Tax Ct. Oct. 5, 2006), at *4 (finding against taxpayer on IRC § 7491 threshold).

Thus, once a taxpayer has met the substantial hurdle of submitting evidence sufficient to satisfy the statute, as well as other requirements, holding the Commissioner to his burden of proof in a meaningful way is appropriate and reasonable as well as consistent with the language of the statute.[7] Certainly the framework suggested by the Second Circuit, where the Commissioner may utterly fail to prove his case and do little (or even nothing) even to refute the taxpayer's case, yet still be found to have "met his burden," negates the clear Congressional intent to right the historic imbalance in tax jurisprudence.

B. Decisions in Conflict with the Second Circuit Decision

The Second Circuit's view of the burden of proof in tax cases, and with respect to Section 7491 in particular, conflicts with that of the Circuit Courts of Appeals and the Tax Court in other jurisdictions.

1. *Decisions of the U.S. Court of Appeals*

The U.S. Court of Appeals for the Fifth Circuit has long recognized the principle that, once the burden of proof shifts to the Commissioner under a statute, he must prove the correct amount of taxes owed. *See,*

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[7] Clearly, as noted above, the Second Circuit's rationale for not holding the Commissioner to his proof — *i.e.*, that it could result in the adoption of substantially "erroneous" taxpayer valuations — is inconsistent with the evidentiary requirements imposed on taxpayers seeking to shift the burden of proof.

e.g., *Carson v. United States*, 560 F.2d 693 (5th Cir. 1977). That principle was applied in a dispute over valuation in *Caracci v. C.I.R.*, 456 F.3d 444 (5th Cir. 2006), where the burden of proof on valuing a closely held business was found to have shifted to the Commissioner.[8] As in the case at bar, the Tax Court rejected the testimony of the Commissioner's valuation expert, but also found fault with the taxpayer's appraisal — and so proceeded to assemble its own appraisal: "The Tax Court adopted only one part of one of [the expert's] market-value approaches, making adjustments and filling in gaps to reach its own conclusion as to value." *Id.* at 454.

Reversing, the Fifth Circuit found that the Tax Court should have simply found for the taxpayer:

> [T]he Tax Court rejected most of the only support the Commissioner provided for the net excess benefit finding, the testimony of the Commissioner's valuation expert. At that point, the Commissioner failed to meet his burden of proof. At that point, the Tax Court should have found in the taxpayers' favor.

Id. at 457-58. This analysis by the Fifth Circuit is in direct conflict with that of the Second Circuit, which held in this case that the Commissioner can be found to have met his burden of proof in a valuation case even if his valuation expert's report and testimony have been rejected in their entirety.

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[8] In this case the burden shifted not pursuant to Section 7491 but, as a matter of case-law, due to "naked assessment." 456 F.3d at 457.

The U.S. Court of Appeals for the Eighth Circuit, in *Griffin v. C.I.R.*, 315 F.3d 1017 (8th Cir. 2003), reversed the ruling of the Tax Court that the taxpayers had failed to establish that they were entitled, under Section 7491, to shift the burden of proof to the Commissioner on whether the taxpayer was entitled to deduct certain real estate payments. Moreover, the *Griffin* court rejected the argument that the burden of proof could be assumed to be of no consequence to the outcome: "[I]f that were the case, § 7491(a) would have no meaning." *Id.* at 1022. Accordingly, the Eighth Circuit directed the Tax Court to hold the Commissioner to his burden of proof and "*prove* the non-applicability" of the exception claimed by the taxpayer by submitting contrary evidence. *Id.* at 1021 (emphasis added). Unlike the Second Circuit, the Eighth Circuit did not suggest that the Commissioner's burden could be met by merely arguing that the taxpayers' case — already deemed credible — was purportedly "undermined" by certain facts already in evidence.

Following the directives of the Court of Appeals, the Tax Court found for the taxpayers after concluding that the Commissioner "has offered insufficient contrary evidence to overcome petitioners' evidence. Accordingly, respondent has failed to sustain his burden of proof." *Griffin v. C.I.R.*, T.C. Memo 2004-64, 2004 WL 440431 (U.S. Tax Ct. Mar. 11, 2004), at *4 (footnote omitted).

The U.S. Court of Appeals for the Ninth Circuit, similarly, has treated the burden of proof as a meaningful and rigorous basis for entering a finding for the taxpayer — and *not* as an invitation to the Tax Court to undertake its own valuation. *See, e.g.*, *Morrissey v. C.I.R.*, 243 F.3d 1145, 1147-48 (9th Cir.

2001), *rev'g and rem'g*, 77 T.C.M. (CCH) 1779 (1999) (ordering that judgment be entered for taxpayer where expert report of Commissioner, who had burden of proof, was rejected by Tax Court, which attempted an independent valuation); *Estate of Simplot v. C.I.R*, 249 F.3d 1191, 1196 (9th Cir. 2001), *rev'g and rem'g*, 112 T.C. 130 (1999) (same).

Finally, the U.S. Court of Appeals for the Seventh Circuit has also held, in a nearly mirror-image context, that when the party with the burden of proof in a valuation case fails to make its case, the Tax Court should ordinarily find that the other party has prevailed outright — rather than try to fashion a valuation of its own. In *JPMorgan Chase & Co. v. C.I.R.*, 458 F.3d 564 (7th Cir. 2006), the Tax Court had rejected the valuation of the taxpayer, who had the burden of proof, but, instead of accepting the Commissioner's valuation, devised a methodology of its own. The Seventh Circuit reversed, holding that, absent a finding that the Commissioner's approach was "arbitrary or unlawful," the Tax Court should have found in the Commissioner's favor. This analysis is, again, in conflict with that of the Second Circuit, which attaches no dispositive consequences to the failure of a party with the burden of proof to prove its own case.[9]

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[9] *See* J. Bogdanski, *supra*, which notes the conflict between *Caracci* and *JPMorgan Chase* on the one hand, and *Estate of Thompson* on the other: the "Fifth and Seventh Circuits have recently issued opinions indicating that when the party with the burden of proof fails to persuade the court of the correctness of its valuation position, the other party to the litigation should prevail outright. That view is not shared by all the federal appeals courts." 2007 WL 4328637.

2. *Decisions of the Tax Court*

Given that relatively few taxpayers have thus far succeeded in meeting the requirements needed to shift the burden of proof under Section 7491, there are a limited number of reported cases involving the interpretation and application of the statute in a valuation setting. One such case, *Kohler v. C.I.R.*, 2006 WL 2059210, *supra*, decided two years after the Tax Court opinion was issued in this case, demonstrates — in striking contrast to the Second Circuit's approach — how Section 7491 can and should be applied in a manner consistent with traditional burden-of-proof principles, legislative intent, and judicial economy.

The *Kohler* Tax Court recognized that the statute is plainly intended to impose a genuine burden-of-proof obligation upon the Commissioner in appropriate circumstances. In *Kohler*, as in this case, the taxpayer cleared the hurdle of complying with all requirements, including the submission of a valuation of a portion of a privately held company supported by credible evidence, to shift the burden to the Commissioner. *Id.* at **6-7. In *Kohler*, as in this case, the Tax Court rejected in its entirety the expert testimony of the Commissioner's appraiser. Based on that finding alone, the Tax Court then, *without any further analysis of the taxpayer's evidence*, found for the taxpayer and adopted the valuation submitted by the taxpayer's expert:

> We therefore give no weight to the respondent expert's conclusions. Respondent [the Commissioner] has therefore not met his burden

> of proof. Accordingly, we find the value of the estate's stock to be the amount the estate reported on its return. . . .

Id. at *13.

Only *after* having made this determination based on the burden of proof, the Tax Court went on to analyze in detail the expert reports submitted by the taxpayer and the Commissioner's arguments in opposition to the persuasiveness of the taxpayer's valuation. The Tax Court stated that these supplemental findings "lend *further* support to our conclusions" (*id.* at *13) (emphasis added), but it made clear that it did not need to have conducted any such additional analysis to reach its ultimate decision. At no point did the Tax Court in *Kohler* suggest that it would have been free to create its own valuation if the Commissioner — having failed to prove his own valuation or submit evidence contradicting the taxpayer's valuation — had merely argued that some fact in the record "undermined" the taxpayer's valuation.

Similarly, in *Forste v. C.I.R.*, T.C. Memo 2003-103, 2003 WL 1889626 (U.S. Tax Ct. April 16, 2003), the Tax Court meaningfully held the Commissioner to his proof once the burden had shifted pursuant to Section 7491. In *Forste*, the issue was whether certain payments received by the taxpayer were made in settlement of tort or tort type personal injury claims and therefore excludable from taxable income. After "extensive arguments" over whether the burden of proof could be shifted, and "before considering any contrary evidence submitted" by the Commissioner, the Tax Court found that the taxpayer had presented "credible evidence; i.e.,

sufficient evidence upon which to base a decision" that the payments at issue qualified for the exclusion. Accordingly, the Tax Court held that the burden of proof on this issue shifted to the Commissioner, who was now required to prove that the payment was *not* intended to settle personal injury claims.

The Tax Court then ruled that the testimony of the sole witness called by the Commissioner clearly failed to satisfy the Commissioner's burden of proving his case, even though the testimony might raise an inference sufficient "to detract from the weight" of the taxpayer's evidence. *Id.* Unlike the Second Circuit, which found that the Commissioner could meet his burden of proof merely by making arguments that detracted from the weight of the Estate's evidence, the Tax Court in *Forste* properly held that, once the burden of proof shifted, the Commissioner had to do much more than that. Given the Commissioner's failure to meet his burden of proof, the Tax Court found for the taxpayer.

C. Summary

Congress intended, with the enactment of 26 U.S.C. § 7491, to provide taxpayers with a substantive measure of relief from the historical disadvantages they faced in litigation with the Internal Revenue Service. The Second Circuit's misapplication of the statute constitutes a barrier to the realization of this legislative goal, as does the conflict and confusion reflected in the case-law (at the appellate level as well as in the Tax Court) surrounding both the interpretation of Section 7491 and, more generally, the application of burden-of-proof principles in tax litigation. Indeed, taxpayers will be discouraged from

even seeking the benefits of burden-shifting under Section 7491 as long as there is such deep uncertainty as to whether the courts will give the statute meaningful effect or render its benefits illusory.

Absent clarification and consistency, an important component of what was intended to be a "Taxpayer's Bill of Rights" is likely to remain unrealized, and Congress's effort to ensure due process for taxpayers will be frustrated. The need for resolution and guidance from this Court is particularly acute and urgent with respect to the burden of proof in estate tax cases and other tax cases that may turn on valuation issues. Unlike the courts of other Circuits, the Second Circuit has held that Section 7491 places no real limitations at all on the Tax Court's ability to substitute itself as the valuation expert whenever the Commissioner — unable to justify his own valuation — merely manages to raise an issue with respect to some aspect of the taxpayer's valuation (which the Tax Court has already subjected to "critical analysis" and deemed credible). This interpretation effectively nullifies the statutory directive to place the "burden of proof" on the Commissioner in valuation cases when the taxpayer meets the required evidentiary threshold. It also undermines the statute's significant potential for maintaining judicial economy by limiting the number of cases in which the Tax Court — which has no expertise in valuation — takes on the role of appraiser, and in which the appellate courts are called on to undertake a full evidentiary review.

CONCLUSION

For the foregoing reasons, a writ of certiorari should be granted.

Respectfully submitted,

JAMES F. RITTINGER
Counsel of Record
ROBERT H. GOLDIE
JOSHUA M. RUBINS
KIRK H. O'FERRALL
SATTERLEE STEPHENS
BURKE & BURKE LLP
230 Park Avenue
New York, New York 10169
(212) 818-9200

Attorneys for Petitioner

United States Court of Appeals, Second Circuit.

Estate of Josephine T. THOMPSON, Deceased, Carl T. Holst-Knudsen, & The Bank of NEW York, Executors,

Petitioners-Appellants-Cross-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Cross-Appellant.

Docket Nos. 06-0815-ag (Lead), 06-1132-ag (XAP).

Argued: April 23, 2007.
Decided: Aug. 23, 2007.

Joshua M. Rubins (Robert H. Goldie and Kirk H. O'Ferrall, on the brief), Satterlee Stephens Burke & Burke LLP, New York, NY, for Appellants.

Richard Farber (Steven W. Parks, on the brief), for Eileen J. O'Connor, Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C., for Appellee.

Before: JACOBS, Chief Judge, LEVAL and POOLER, Circuit Judges.

DENNIS JACOBS, Chief Judge:

For estate tax purposes, the United States Tax Court (Swift, J.) valued one-fifth of a closely held company at $13.5 million — an amount far above the $1.75 million valuation proffered by the estate of Josephine T. Thompson ("Estate") and far below the $32 million valuation proffered by the Commissioner of Internal Revenue ("Commissioner") — and declined to impose an underpayment penalty against

the Estate, principally on the grounds that the Commissioner's estimate was so high in the other direction and that the valuation issues were fairly debatable. The Court found that the Estate employed a method that exaggerated the risks associated with technological change, while the Commissioner's methodology was generally deficient. The Estate appeals chiefly on the ground that, pursuant to § 7491 of the Internal Revenue Code ("IRC"), the burden of proof on the issue of valuation shifted to the Commissioner when (as the parties have stipulated) the Estate introduced credible evidence on the issue, and that the Tax Court was therefore compelled to adopt the Estate's valuation once it rejected the Commissioner's. The IRS appeals chiefly on the ground that the Estate's underpayment was such that it was error for the Tax Court to refuse to impose an underpayment penalty.

We vacate the judgment because there is a conceded error in the Tax Court's calculation and because the Court's findings are insufficient to support the application of the reasonable cause exception to the otherwise mandatory underpayment penalty. We remand for further proceedings consistent with this opinion.

I

When Josephine T. Thompson died on May 2, 1998, her estate included approximately 20% of the common shares of Thomas Publishing Co., Inc. (the "Company"), a century-old private, closely held corporation which produces business-to-business industrial and manufacturing directories and publications. Descendants of the Company's founder

own almost 90% of the shares; no shares have ever been publicly traded; and no stock sales had occurred in the ten years prior to Thompson's death.

The Company's business was solely paper-based until the 1990s, when it began to adapt to the digital marketplace. The Company offered its directories on CD-ROM in 1993, and made its directories available free on the Internet in 1995. By 1998, the Company's website was recognized as the sixth-ranked business-to-business website in the United States. From 1995 to 1998, print subscriptions fell while CD-ROM and Internet subscriptions increased dramatically. *See Estate of Thompson v. Comm'r*, T.C.M. (RIA) 2004-174, 2004 WL 1658404, at *2-*4 (July 26, 2004).

In the six years preceding Thompson's death (1993-1998), the Company's net sales revenue grew 53% but expenses kept pace; thus during that period operating income stayed constant around $25 million. In the years following Thompson's death, net sales revenue averaged $273 million for three years (1999-2001), then dropped to $235 million (2002), while operating expenses grew 9% over three years (falling in the fourth year), so that operating income dropped, turned to losses, and the Company ended 2002 barely breaking even.

II

For estate tax purposes, the Estate calculated the value of Thompson's share of the Company at $1.75 million using the capitalization of income method, under which a company's value is calculated by [i] projecting the company's annual income, [ii] determining a company-specific capitalization rate,

[iii] dividing the projected income by the capitalization rate, and [iv] adding the value of non-operating assets.

The Estate projected the Company's annual income to be $7.9 million (the average from 1993-1997 minus $10 million in projected technology expenditures), then used a capitalization rate of 30.5% based on: [1] a 6% risk-free base rate of return; [2] a 7.8% equity risk premium; [3] a 4.7% small-stock risk; and [4] a 12% Internet and management risk. No non-operating assets were added. This yielded a valuation of $25.8 million for the Company, of which the Estate's share was $5.3 million, which was then further reduced (by 40%) to account for the Estate's minority ownership interest and (by a further 45%) to account for lack of marketability, to arrive at the final valuation of $1.75 million. The Estate argues that this valuation reflects grim prospects in 1998 and the Internet's "substantial threat to TPC's viability as a business."

The Commissioner valued the Estate's interest at $32 million, using two independent methods: the comparable public company method, which yielded a Company value of $260 million; and the discounted cashflow method, which was performed twice (using different estimated future values) and which yielded Company values of $212.6 million and $158.8 million.[1] The Commissioner settled on $225 million, of which the Estate's share was $46.3 million. That value was then discounted by 30% to account for lack of marketability, thus arriving at the final value of

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[1] Because the Tax Court ultimately rejected the Commissioner's valuation, and the Commissioner does not appeal that rejection, we only briefly summarize the Commissioner's methodology.

$32 million. The Commissioner contends that his valuation more accurately reflects the state of affairs in 1998, when there was no reason to think that the Internet would have the deleterious effect on TPC's business that occurred from 2000 to 2002.

III

The Tax Court rejected both of the parties' valuations as "deficient and unpersuasive," *Estate of Thompson,* 2004 WL 1658404, at *17, on the following grounds: The Commissioner's valuation was rejected because the comparable companies chosen were insufficiently similar to the Company, *Id.* at *20, and the discounted cashflow analysis contained "significant errors" and "suspect" recalculations, *Id.* at *21; the Estate's valuation was rejected because it improperly included a 12% Internet and management risk factor in the capitalization rate, erroneously omitted certain non-operating assets, and inflated the discounts for minority interest and lack of marketability, *Id.* at *19-*20.

The Tax Court further criticized the Estate for its decision to "hire[ ] a lawyer and an accountant from Alaska, both with relatively little valuation experience, to value the estate's 20-percent interest in TPC" given that "the estate, the executors of the estate, and the underlying company, the stock of which is being valued, were all headquartered and based in the New York City metropolitan area." *Id.* at *17.

The Court then undertook its own valuation, employing the capitalization of income method. The Court adopted the Estate's projected annual income of $7.8 million, but used a capitalization rate of

18.5% (having eliminated the 12% Internet and management risk factor which had bumped the Estate's number to 30.5%). Dividing $7.8 million by 18.5% yielded a subtotal of $42.5 million. To that, the Court added $68 million in short-term investments, which the Court considered non-operating assets (but which the Estate had considered operating assets, and therefore omitted from its valuation). Thus the Court arrived at a total value of $111 million for the Company. The Estate's $22.7 million share (20%) was then reduced by 15% to account for the Estate's minority interest and 30% for lack of marketability (compared to the Estate's 45% and 40%, respectively), which yielded the Court's valuation of the Estate's share of the Company: $13.5 million. *Id.* at *22.

IV

The valuation of a company is a factual issue. *See Silverman v. Comm'r*, 538 F.2d 927, 931 (2d Cir. 1976). Under IRC § 7491, "[i]f . . . a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer . . ., the Secretary shall have the burden of proof with respect to such issue." 26 U.S.C. § 7491(a)(1). The parties stipulated that the Estate submitted "credible evidence" in support of its valuation. See *Estate of Thompson*, 2004 WL 1658404, at *24 n. 6. Accordingly, the burden of proof shifted to the Commissioner on the issue of valuation. The Estate argues that the Commissioner necessarily failed to satisfy his burden. It contends that, under § 7491, the Tax Court's rejection of the valuation proffered by the Commissioner required the Court to adopt the Estate's competing valuation. We disagree.

Before the enactment of § 7491, "a deficiency determined by the Commissioner [was] presumptively correct and the taxpayer [bore] the burden of disproving it." *Silverman,* 538 F.2d at 930. Section 7491 reallocated the burden. However, this reallocation does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value; the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation.

Here, the Commissioner not only presented evidence in support of his own valuation; he also cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with the Company's investments in Internet-related projects. Notwithstanding the enactment of § 7491, it remains the case that (as we said in 1976) the "Tax Court is not bound by the formulas or opinions proffered by expert witnesses. It may reach a determination of value based upon its own analysis of all the evidence in the record."[2] *Id.* at 933.

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[2] Because the Tax Court adopted some of the Commissioner's arguments in opposition to the Estate's valuation, we have no occasion to decide whether § 7491 would require a court to adopt a taxpayer's valuation if the court rejected all arguments advanced by the Commissioner in opposition to that valuation, or if the Commissioner made no such arguments.

V

In the alternative, the Estate argues that, in arriving at its independent valuation, the Tax Court erred by [i] counting $68 million in short-term investments as non-operating assets, which were therefore added to the figure for the Company's capitalized income; and [ii] omitting a technology-related risk factor in its capitalization rate. "The Tax Court's valuation is a factual finding conclusive upon review if not clearly erroneous." *Id.* at 931. "[O]ur powers of review are very . . . limited upon all issues of fact, and that limitation is particularly narrow when the issue is one of value." *Sisto Fin. Corp. v. Comm'r*, 149 F.2d 268, 269 (2d Cir. 1945); *see also Silverman*, 538 F.2d at 931. There is evidence to support both of the challenged features of the Tax Court's valuation.

We therefore affirm the Tax Court's valuation in all respects but one: the parties agree that the Tax Court made an error in calculation. As set out in the prior paragraph, the Court treated $68 million in short-term investments as non-operating assets, and therefore added $68 million to the Company's capitalized income. But when the Court calculated the Company's projected income, it included the income produced by the $68 million in its projection, thus factoring in the $68 million twice. The Commissioner estimates that this error resulted in a $1.2 million overstatement in the value of the Estate's shares; the Estate (which agrees that the error was made) does not attempt to quantify its effect. We therefore remand for the Tax Court to correct this double-counting error. We affirm the Tax Court's valuation in all other respects.

VI

The Tax Court determined that the Estate's share of the Company was worth $13.5 million; the Estate valued its share at $1.75 million-less than 15% of the value determined as correct by the Court.[3] Under the version of IRC § 6662 then in effect, if the claimed value of the Estate is not more than 25% of the amount determined to be correct, the taxpayer must pay an accuracy-related penalty equal to 40% of its underpayment. *See* 26 U.S.C. § 6662(a), (g)(1), (h)(1), (h)(2)(C) (2006), *amended by* Pension Protection Act of 2006 § 1219, Pub.L. No. 109-280, 120 Stat. 780, 1083 (2006). With one exception, this penalty is mandatory. *See Id.* § 6662(a) ("there *shall* be added to the tax an amount equal to [40] percent of the . . . underpayment" (emphasis added)). An exception is *allowed* if "it is shown that there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such [underpayment]." *Id.*§ 6664(c)(1).

The Tax Court invoked this reasonable-cause exception and declined to impose an accuracy-related penalty. Its decision was based on the following considerations: [i] the valuation "was particularly difficult and unique"; [ii] the valuation "involved a number of difficult judgment calls"; [iii] the valuation was "difficult and imprecise" because of "the difficult question as to how the Internet and the risks and opportunities associated therewith should be

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[3] We recognize that the Tax Court's final valuation of the Estate may be somewhat different when the double-counting error is fixed. Nonetheless, it appears that the reduction in valuation will not be sufficient to bring the Estate's valuation above 25% of the court's ultimate determination.

regarded as affecting TPC"; and [iv] while "the experts for the estate were aggressive in their relatively low valuation of TPC," the Court's own valuation was "closer to the estate's valuation than to [the Commissioner's] valuation." *Estate of Thompson*, 2004 WL 1658404, at *23.

"We review the tax court's factual determinations of whether a taxpayer qualifies for the reasonable cause exception for clear error." *Sather v. Comm'r*, 251 F.3d 1168, 1177 (8th Cir. 2001); *accord Van Scoten v. Comm'r*, 439 F.3d 1243, 1260 (10th Cir. 2006). However, while it is a question of fact whether "the elements that constitute 'reasonable cause' are *present* in a given situation," it is a question of law "what elements *must* be present to constitute 'reasonable cause.'" *United States v. Boyle*, 469 U.S. 241, 249 n. 8, 105 S.Ct. 687, 83 L.Ed.2d 622 (1985). Accordingly, we review the factual determinations for clear error, but we review de *novo* whether those determinations were sufficient to satisfy the elements of reasonable cause.

Under agency regulations, the existence of reasonable cause is determined "on a case-by-case basis, taking into account all pertinent facts and circumstances. . . . Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." 26 C.F.R. § 1.6664-4(b)(1). "Reliance on . . . an appraiser does not necessarily demonstrate reasonable cause and good faith," but such reliance does satisfy the reasonable cause exception if, "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." *Id.* Thus reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have

known, that the advisor lacked knowledge in the relevant aspects of Federal tax law." *Id.* § 1.6664-4(c)(1).

The Tax Court's findings are insufficient to support a determination of reasonable cause under § 6664. The factors set out in the regulations search the good faith of the taxpayer-either in assessing its own liability or in relying on an expert to do so. But the Tax Court made no finding as to whether the Estate's reliance on its experts was reasonable and in good faith, or whether the Estate knew or should have known that they lacked the expertise necessary to value the Company.

To prepare its valuation of a New York publishing company, the Estate turned to George E. Goerig of Anchorage, Alaska. The Tax Court found that an Alaska lawyer was retained so that the Commissioner's audit of the Estate would not be conducted by the Commissioner's New York staff, but by the Commissioner's office in Alaska, "where Goerig believed and apparently represented to the estate's representative that he would be able to obtain for the estate a more favorable valuation of the estate's [Company] stock." *Estate of Thompson,* 2004 WL 1658404, at *8."[T]he estate had learned about Goerig from an attorney for decedent's family who had met Goerig on a fishing trip." *Id.*

Goerig was assisted by Paul Wichorek, an accountant in the same remote location. *Id.* The Court found that these experts "demonstrated no experience with . . . Internet and technology-related companies," *Id.* at *11, and were "too inexperienced,

accommodating, and biased in favor of the estate," *Id.* The Court summarized their qualifications as follows:

> Goerig is a lawyer with an audit and tax dispute resolution practice, and a tax return preparer, and he undertakes occasional valuations for small businesses and private individuals. From his resume, he appears to have attended limited appraisal courses, other than a few courses while working for [the Commissioner] many years ago. Goerig also was appointed to act as administrator for the estate to handle the anticipated audit by respondent of the estate's Federal estate tax return, a role which we regard as somewhat in tension with his role as a purported independent valuation expert for the estate.
>
> Wichorek provides accounting and tax preparation services, does business consulting, and undertakes occasional valuations for small businesses, generally in the context of divorce and property settlement disputes. He belongs to no professional organizations or associations relating to his appraisal or valuation work.
>
> Although we admitted into evidence the estate's valuation reports and treated them as credible, we regard those reports and the testimony of the estate's experts to be only marginally credible. Goerig and Wichorek were barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars.

Id. at *17-*18.

A determination as to the Estate's good faith is required. Accordingly, we vacate the Tax Court's decision not to impose an accuracy-related penalty, and we remand so that the Court can determine whether the Estate's reliance on Goerig and Wichorek was reasonable and in good faith.

* * *

For the foregoing reasons, the judgment of the Tax Court is vacated and remanded for further proceedings consistent with this opinion.

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

ESTATE OF JOSEPHINE T. THOMPSON, DECEASED, CARL T. HOLST-KNUDSEN and THE BANK OF NEW YORK, EXECUTORS, Petitioner	Docket No. 4939-02
v.	
COMMISSIONER OF INTERNAL REVENUE, Respondent	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, T.C. Memo. 2004-174, filed July 26, 2004, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in estate tax due from petitioner in the amount of $3,397,255.91. It is further

ORDERED AND DECIDED: That there is no penalty due from petitioner under the provisions of I.R.C. Sec. 6662.

/s/ Stephen J. Swift
Stephen J. Swift
Judge

ENTERED: NOV -3 2005

United States Tax Court.

ESTATE OF Josephine T. THOMPSON, Deceased, Carl T. Holst-Knudsen and the Bank of New York, Executors,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

No. 4939-02.

July 26, 2004.

Kirk H. O'Ferrall, Robert H. Goldie, Jonathan G. Blattmachr, Andrew E. Tomback, Edward A. Stelzer, and Jonathan W. Wolfe, for petitioner.

Robert A. Baxer and Joseph J. Boylan, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, J.

Respondent determined a deficiency of $17,910,408 in the Federal estate tax of the estate of decedent Josephine T. Thompson and a $7,164,163 accuracy-related penalty under section 6662(a).

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect on May 2, 1998, the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The issues for decision are: (1) The fair market value of 487,440 shares of the voting common stock

of Thomas Publishing Co., Inc. (TPC), that were owned by decedent on her death; and (2) whether the estate is liable for the accuracy-related penalty.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

On May 2, 1998, the date of her death, decedent resided in New York.

On May 14, 1998, Carl T. Holst-Knudsen (Holst-Knudsen), decedent's son, and The Bank of New York were appointed by the Surrogate Court of the State of New York, County of Westchester, as co-executors of decedent's estate. Holst-Knudsen resides in New Jersey, and The Bank of New York is headquartered in New York City.

TPC is a private, closely held corporation that was formed over 100 years ago, on January 28, 1898, as a New York corporation. At the time of trial, TPC's principal place of business was located in New York City.

The 487,440 shares of TPC voting common stock that decedent owned constituted 20.57 percent (hereinafter generally rounded to 20 percent) of TPC's total outstanding common stock. Decedent's shares constituted the largest block of TPC common stock owned by any single stockholder.[1]

[1] Decedent also owned 237.6 shares of TPC nonvoting preferred stock the value of which is not in dispute.

On May 2, 1998, all but 300,000 shares of the remaining TPC common stock were owned by approximately 20 other relatives of Harvey Mark Thomas, the founder of TPC.

Holst-Knudsen was designated as the sole testamentary beneficiary of decedent's 487,440 shares of TPC common stock. As of May 2, 1998, taking into account the 162,000 shares of TPC common stock that he already owned and the 487,440 shares that he inherited from decedent, it appears that Holst-Knudsen individually and beneficially owned 649,440 shares of TPC stock or approximately 27 percent of the total outstanding TPC common stock.

The last 300,000 shares of TPC common stock, representing 12.66 percent of the total outstanding TPC common stock, were owned by an outside stockholder-namely, Capital Cities/ABC, Inc., a New York Stock Exchange publicly traded company.[2] As of the date of decedent's death, Capital Cities/ABC, Inc., or its predecessor, apparently had owned these shares of TPC common stock for at least 10 years.

During 1998 and subsequent years through the time of trial in 2003, Holst-Knudsen was president and Jose E. Andrade was chairman of the TPC board of directors. Both Holst-Knudsen and Andrade are grandsons of Harvey Mark Thomas, TPC's founder.

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[2] In 1996, the Walt Disney Co. (Disney) acquired Capital Cities/ABC, Inc., for $19 billion. The TPC stockholder list in evidence apparently does not take into account this 1996 Disney acquisition and therefore provides the former name of this outside TPC stockholder. Herein, we refer to this stockholder as shown on TPC's stockholder list.

None of the shares of TPC common stock has ever been publicly traded, and, in the 10 years before decedent's death and in the years after decedent's death through the time of trial, no sales of TPC common stock occurred. Also, as of May 2, 1998, no buy/sell agreement or stockholder agreement affecting the value of TPC common stock was in existence.

Over the years, TPC's primary business has been the production and sale of industrial and manufacturing business guides and directories. TPC's business directories provide detailed information on products and services, company profiles, contact information, and catalog files.[3]

As of May 2, 1998, TPC published and sold throughout the United States and abroad approximately 24 business-to-business industrial business directories, including the Thomas Register of American Manufacturers (the Thomas Register), TPC's 34-volume directory which is recognized throughout North America as the most comprehensive resource for finding manufacturing companies and products. TPC also published and sold a variety of news magazines, software comparison guides, and a magazine relating to factory automation, and it owned a product information exchange service and a custom publishing group.

By any measurement, as of May 2, 1998, TPC was regarded as a very successful and profitable company

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[3] The first buying directory was published by Harvey Mark Thomas in 1890, prior to incorporation of the business, and was titled "Thomas' Machinery, Iron, Steel, and Metal Trades Reference Book".

and by some as holding an effective monopoly in the United States on business-to-business industrial and manufacturing print publications.

In its own publications, TPC describes itself as follows:

> Thomas Publishing Company
>
> Your product information headquarters
>
> For more than 95 years, Thomas Publishing Company has concentrated its full energies on filling one of industry's greatest needs . . . the need for *up-to-date product information.* No other publisher is as totally dedicated to this mission.
>
> Decision makers throughout industry need *product information* to operate their companies successfully. Regardless of job function, the hunger for *up-to-date product information* is universal. It's given priority attention because industry's appetite for products and services of every type is enormous. It can be filled only when buying influences have comprehensive, reliable, up-to-date vendor information. It influences profitability profoundly because dozens of new products enter the marketplace daily-providing new functional and economic benefits. To not keep up with these developments means operating without the benefit of these improvements. And ultimately that means relinquishing market position to one's competitors.
>
> Thomas Publishing Company has become the acknowledged leader in providing industry with the *product information* it needs. Today, we

publish twenty-four major buying guides, thirty-one product news magazines, two product information exchange services, a magazine on factory automation, and a publication to help buyers select the most cost-efficient transportation modes for their inbound freight. In addition, Thomas Business Lists offers comprehensive list services for direct marketing. Also, the Thomas Marketing Information Center helps industrial marketers research and respond to industry's need for new products. All of these services are described in the pages that follow.

Published annually, *Thomas Register of American Manufacturers* is by far the most complete and helpful specifying and buying guide published today. It provides "instant" sourcing information on nearly 52,000 industrial products and services, along with comprehensive specifications and availability information from thousands of manufacturers. In all, more than 1,500,000 individual product/service sources are included. Thomas Register also contains a complete 2-volume Company Profiles section and a comprehensive 8-volume Catalog File section. Headquarters and branch addresses, phone numbers and asset ratings are provided on more than 148,000 U.S. firms.

For everyone involved in specifying and buying industrial products and services, Thomas Register is invaluable. For everyone involved in selling industrial products and services, Thomas Register is invaluable. [22 Thomas Register of American Manufacturers 3573 (86th ed. 1996).]

The primary sales force for TPC directories was made up of independent salespersons located throughout the United States and Canada. The salespersons were paid on a commission basis with the right to receive commission advances from TPC.

In the early 1990s, the development and increased use of electronic and digital media provided alternatives to the form and manner in which information could be packaged and distributed. For example, the development of CD-ROM format facilitated the transmission of large amounts of data quickly and permitted the user to sort and to access data in different ways.

Also, the development and expansion of the Internet and of Internet search engines allowed traditional buyers of TPC's directories, to a certain extent, to locate and to purchase products on their own without reference to TPC's print directories.

Historically, TPC's buying directories were published only in print or paper format. By the early 1990s, however, it was recognized by TPC's management that the Internet and other technological advances would have an impact on TPC's business, presenting to TPC special challenges, risks, and new competition, but also providing to TPC new growth opportunities.

In 1993, in response to the significant advancements in technology and to increased use by business entities of electronic media, TPC began publishing and offering some of its business-to-business buying directories on CD-ROM.

In 1994, in an internal TPC management publication, the Thomas Register was described as

"the undisputed leader * * * in electronic publishing" relating to business-to-business buying directories. Also, in that same internal publication, a TPC management objective (relating to TPC's continuing competitive position with electronic publishing) was stated as follows:

> Finding ourselves now at such a juncture, we seek an approach to securing for * * * [TPC] a dominant position in the electronic interchange of information among industrial buyers and sellers comparable to that which it has enjoyed in the hard copy realm.

In early 1995, although TPC's management recognized that TPC's historical existence as a print publisher constituted a certain liability in the new electronic environment, TPC's management also recognized that TPC brought "to the competitive electronic information wars ahead" certain "great assets" which were described as "the information that it traffics and the methodologies, relationships and brand name recognition that support that traffic".

In 1995, TPC began publishing and making its directories available for free on the Internet. The record does not indicate exactly on which dates TPC's various directories became available on the Internet.

At TPC's 1996 annual stockholder meeting, Holst-Knudsen gave a speech in which he acknowledged that the rapid advancements in technology created uncertainty for the future of TPC, but in which speech Holst-Knudsen also stated that the technological advancements that were occurring constituted a "great" opportunity for TPC.

A colorful excerpt from a January 1998 TPC publication comments on the positive manner by which TPC's management, as of early 1998, was addressing and dealing with the technological challenges TPC faced:

> As the company's flagship, Thomas Register absorbs the brunt of competitive initiative from the various evil empires aiming to unseat us in the new digital world. Asked to respond with a major Internet launch in 1996 and to add to that a major CD-ROM program in 1997 * * * [Thomas Register's] production, editorial, circulation, sales and administrative people have handled a hailstorm of change and complexity with energy and skill that few would have been bold enough to anticipate only three years ago.

By early 1998, ThomasRegister.com was recognized as one of the 200 leading business-to-business Web sites in the United States. Among the 200 Web sites so recognized, TPC's Web site was ranked sixth.

For its fiscal years 1993-98, the number of purchasers or subscribers to TPC's print and CD-ROM directories, and the number of subscribers to TPC's Internet directories are set forth below:

Fiscal Year	Print Subscribers	CD-ROM Subscribers	Internet Subscribers
1993	73,500	1,000	N/A
1994	78,000	2,500	N/A
1995	81,000	5,000	40,000
1996	80,000	13,000	225,000
1997	67,500	25,000	550,000
1998	45,500	45,500	*

Historically, TPC's revenue was generated from the sale of subscriptions to and advertising in its print directories. For the last 30-plus years, the largest percentage of TPC's revenue was generated from the sale of advertising. For example, for its fiscal year 1972, advertising revenue associated with TPC's directories accounted for 86 percent of TPC's total revenue. By its 1993 fiscal year, advertising revenue associated with TPC's directories accounted for more than 90 percent of TPC's total revenue.

Set forth below for each of TPC's fiscal years 1993-2002 are the numbers for TPC's subscription and advertising revenue and the percentage of TPC's total sales revenue reflected by subscription revenue and by advertising revenue:

(table on page A-27)

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* Not in evidence.

Fiscal Year	Subscription Revenue	Advertising Percentage of Total Sales Revenue	Revenue	Percentage of Total Sales Revenue
1993	$14,901,781	8.3	$165,386,826	91.7
1994	15,310,520	7.9	177,924,154	92.1
1995	16,978,851	7.9	197,451,678	92.1
1996	17,173,690	7.4	215,653,261	92.6
1997	17,240,197	6.7	239,828,771	93.3
1998	14,068,891	5.2	257,901,815	94.8
1999	8,834,385	3.0	284,004,912	97.0
2000	6,580,888	2.2	291,617,859	97.8
2001	*	*	*	*
2002	957,646	0.4	249,187,069	99.6

* Not in evidence.

For 1993-2002, decreases in TPC's subscription revenue generally coincided with TPC making its directories available on CD-ROM and on the Internet. For 1993-2000, however, increases in TPC's advertising revenue relating to CD-ROM and Internet versions of its directories, more than offset decreases in TPC's subscription revenue.

For its fiscal years 1998-2002, TPC's combined subscription and advertising revenue relating to its respective print, CD-ROM, and Internet directories is set forth below:

(table on page A-29)

In addition to developing and implementing technology to make its directories available on CD-ROM and on the Internet, TPC engaged in other technology projects. A list and a brief description of other technology-related projects undertaken by TPC during its 1995-2002 fiscal years are set forth below:

(1) Development of the nationally recognized TPC Web site;

(2) Development of TPN Register, a joint venture between TPC and General Electric Co., through which product information similar to information contained in TPC's directories was to be provided to companies via each company's respective internal intranet. In 2001, TPC apparently terminated this TPN Register project;

(3) Development of Thomas.Net, a software product that enabled users to use keywords to make online digital searches of TPC's electronic directories for industrial product information;

Fiscal Year	Combined Subscription and Advertising Sales Revenue Print Directories	CD-ROM Directories	Internet Directories	Multimedia*
1998	$60,974,928	$21,545,793	$3,801,224	$190,135,238
1999	55,183,301	30,148,498	11,701,065	196,831,426
2000	49,567,582	32,233,952	20,295,520	196,595,142
2001	40,320,705	29,578,071	27,962,016	187,279,835
2002	29,054,729	24,285,826	29,485,156	167,486,238

* Multimedia sales revenue reflects the sale of bundled advertising in TPC's print, CD-ROM, and Internet directories. Revenue numbers in this table do not match up entirely with the revenue numbers in the table above.

(4) Development of Product News Network (PNN), an electronic magazine containing information regarding new industrial products;

(5) Development in 1995 of Thomas Global Register (TGR), an Internet directory for TPC's customers located outside the United States; and

(6) Purchase in 1997 of Plant Spec, a Web-based software system that permitted the electronic transfer of computer assisted design (CAD) drawings.

During its 1995-97 fiscal years, TPC spent approximately $36 million on the above technology-related projects. As of May of 1998, TPC's management anticipated that during 1998-2002 TPC would undertake additional projects, incur additional expenditures, and realize additional income relating to technology-related projects.

During its 1998-2002 fiscal years, TPC's actual expenditures associated with development and marketing of technology-related projects totaled approximately $234 million.[4]

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[4] Apparently, for Federal income tax purposes and in the valuations made by the estate's experts herein, TPC treated all of its technology-related expenditures as current ordinary and necessary business expenses, rather than as capital expenditures. Respondent herein complains mildly about such current expense treatment but stops short of asserting that the technology-related expenditures should have been capitalized and stops short of asking that TPC's financial statements and financial projections be redone to treat such expenditures as capital in nature.

Set forth below are TPC's technology-related expenditures for its 1995-2002 fiscal years:

(table on pages A-32–33)

For its 1993-2000 fiscal years, TPC's reported financial statements reflect steady, consistent, and increasing revenue and show that TPC was profitable through the end of its 1999 fiscal year. As reported, for each of 1993-2000, TPC realized record total revenue and, as of the end of TPC's 1997 fiscal year, TPC's financial data reflected shareholder equity of $148,605,729.

As of May of 1998, TPC had reported positive net income for every year for the prior 24 years, and the then-current in-house management financial forecast for TPC estimated net profits for 1998.

In late 1997, TPC's senior management, while acknowledging significant challenges, predicted that 1998 would be better than 1997 and "our best [year] ever."

For each of its 1993-98 fiscal years, TPC's net sales revenue, expenditures (including TPC's technology-related developmental expenditures), operating income, and total net income, as reported on TPC's financial statements, are reflected in the table below:

(table on page A-34)

Fiscal Year	TPC Web Site	TPN Register	Thomas. Net	PNN	Plant Spec	TGR	Misc	Total
1995	$-	$2,901,153	$-	$- % B5	$-	$-	$1,310,520	$4,211,673
1996	3,450	7,283,842	462,942	N/A	-	1,131,845	2,336,691	11,218,770
1997	3,692,116	8,133,557	1,670,582	1,639,314	20,818	3,740,603	2,146,855	21,043,845
1998	6,220,263	6,583,382	3,681,100	3,567,351	7,867,906	4,092,326	2,420,544	34,432,872

(Table Continued on Page A-33)

Fiscal Year	TPC Web Site	TPN Register	Thomas. Net	PNN	Plant Spec	TGR	Misc	Total
1999	3,348,521	5,800,000	5,908,513	3,619,148	7,445,476	5,832,464	6,120,977	38,075,099
2000	6,534,901	16,359,397	6,376,417	2,278,640	10,459,145	9,383,771	16,772,912	68,165,183
2001	8,519,175	3,700,000	5,797,868	2,278,640	9,955,829	9,383,771	16,352,359	55,987,642
2002	7,869,933	-	4,173,741	930,655	4,547,589	9,423,411	8,101,439	35,046,768
TOTAL	$36,188,359	$50,761,331	$28,071,163	$14,313,748	$40,296,763	$42,988,191	$55,562,297	$268,181,852

Fiscal Year	Net Sales Revenue	Expenditures	Operating Income	Total Net Income
1993	$168,059,000	$142,602,855	$25,456,145	$14,333,288
1994	179,287,018	148,510,315	30,776,703	12,804,431
1995	200,487,153	170,208,645	30,278,508	11,107,716
1996	216,924,156	199,871,672	17,052,484	13,171,595
1997	240,116,975	217,559,833	22,557,142	15,927,549
1998	256,806,493	231,436,437	25,370,056	18,024,858

Also at the end of each of its 1993-98 fiscal years, TPC owned substantial liquid short-term investments and marketable securities as set forth below:

Fiscal Year	Short-Term Investments	Marketable Securities	Total Liquid Investments
1993	$38,052,200	$10,264,800	$48,317,000
1994	45,640,865	12,050,249	57,691,114
1995	52,919,162	18,292,503	71,211,665
1996	50,915,037	21,986,280	72,901,317
1997	68,993,367	28,261,773	97,255,140
1998	68,687,060	29,988,533	98,675,593

For each of its 4 fiscal years (1999-2002), subsequent to the year in which decedent died, TPC's net sales revenue, expenditures (including TPC's technology-related developmental expenditures), operating income or loss, and total net income or loss, as reported on TPC's financial statements, are reflected in the table below:

(table on page A-36)

At the end of each of its 1999-2002 fiscal years, TPC continued to own substantial liquid short-term investments and marketable securities as set forth below:

Fiscal Year	Net Sales Revenue	Expenditures	Operating Income (Loss)	Total Net Income (Loss)
1999	$273,386,403	$253,677,683	$19,708,720	$14,988,447
2000	278,741,064	282,500,513	(3,759,449)	(5,477,876)
2001	267,003,996	278,332,392	(11,328,396)	(13,807,358)
2002	234,832,485	234,323,041	509,444	1,738,420

Fiscal Year	Short-Term Investments	Marketable Securities	Total Liquid Investments
1999	$77,529,513	$36,787,208	$114,316,721
2000	32,501,250	45,582,058	78,083,308
2001	20,279,591	37,594,522	57,874,113
2002	27,752,994	34,207,692	61,960,686

TPC had a long history of paying annual cash dividends to its stockholders. In each of its 1993-2002 fiscal years, including in its 2 loss years of 2000 and 2001, TPC paid cash dividends on its outstanding common stock ranging from a low of $.85 per share in its 1993 fiscal year to a high of $3.21 per share in its 1998 fiscal year. The total and the per-share cash dividends paid by TPC in its 1993-2002 fiscal years to its common and to its nonvoting preferred stockholders is set forth below:

Fiscal Year	Total Cash Dividends	Cash Dividends Per Share Common	Preferred*
1993	$2,022,900	$0.85	$6
1994	2,259,900	0.95	6
1995	2,259,900	0.95	6
1996	2,259,900	0.95	6
1997	2,615,400	1.10	6
1998	7,616,100	3.21	6
1999	2,615,400	1.10	6

* TPC only had 1,400 shares of nonvoting preferred stock and approximately 99 percent of TPC's cash dividends paid each year were paid to TPC's common stockholders.

2000	2,615,400	1.10	6
2001	2,828,700	1.10	6
2002	2,899,800	1.22	6

As of May of 1998, TPC's management planned to continue paying annual cash dividends to its stockholders.

As of the date of decedent's death in May of 1998, the management of TPC had no intent to liquidate or to sell TPC.

In the early fall of 1998, in anticipation of the filing of a Federal estate tax return on behalf of the estate, even though he lived in Alaska, the executors of the estate hired George E. Goerig (Goerig), an Alaskan lawyer to appraise and to prepare a valuation report for the estate's 20-percent stock interest in TPC.

Also, on November 16, 1998, the executors of the estate filed a petition with the Surrogate Court of the State of New York, County of Westchester, requesting that limited estate administrative powers be granted to Goerig for the purposes of representing decedent's estate in connection with the anticipated audit by respondent of the estate's Federal estate tax return and of handling the anticipated negotiations with respondent over the fair market value of decedent's 487,440 shares of TPC stock. On December 18, 1998, the court granted to Goerig such limited estate administrative powers.

The acknowledged reason the estate hired Goerig (to value the TPC stock owned by decedent and to represent the estate as administrator) was to have respondent's audit of decedent's Federal estate tax return conducted not by respondent's New York City

office but by respondent's Alaska office, where Goerig believed and apparently represented to the estate's representative that he would be able to obtain for the estate a more favorable valuation of the estate's TPC stock.

Executors for the estate had learned about Goering from an attorney for decedent's family who had met Goerig on a fishing trip.

TPC's financial books and records were maintained on the basis of a fiscal year ending September 30.

On approximately February 2, 1999, the executors of the estate timely filed on behalf of the estate a Federal estate tax return, whereon the estate, based on a valuation report of Goerig and Paul M. Wichorek (Wichorek), an Alaskan accountant whom Goerig had hired to assist him in the valuation, reported a total value of $1,750,000 for the estate's 20-percent stock interest in TPC, or $3.59 per share ($1,750,000 / 487,440 shares = $3.59 per share).

On audit, based on a valuation report dated November 9, 2000, prepared by Brian C. Becker, a valuation expert hired by respondent, respondent determined a total value of $35,273,000 for the estate's 20-percent stock interest in TPC, or $72.36 per share ($35,273,000 / 487,440 = $72.36), and respondent determined an estate tax deficiency of $17,910,408. Respondent also determined that the entire $17,910,408 estate tax deficiency determined was attributable to a substantial understatement and therefore that under section 6662 the estate was subject to a $7,164,163 gross valuation understatement penalty.

Shortly before trial, respondent's expert prepared a revised valuation report in which respondent's expert adjusted downward his valuation of the estate's 20-percent TPC stock interest from $35,273,000 to $32,387,730, or from $72.36 per share to $66.45 per share ($32,387,730 / 487,440 = $66.45).[5]

Respondent's expert's revised valuation of the estate's TPC stock interest was necessitated by errors in his original report. In his original valuation, respondent's expert had added back to his calculation of TPC's 1997 cashflow (which was the basis for his TPC cashflow estimates for 1998-2002) deferred income taxes of $13,294,000, although the correct amount of deferred taxes that should have been added back to TPC's 1997 cashflow was only $1,609,793.

Also shortly before trial, the estate's experts prepared an "updated" or revised valuation report to make the estate's original report "more readable", in which revised report the estate's experts again opined that the May 2, 1998, date-of-death value of the estate's TPC common stock was $1,750,000, or $3.59 per share.

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[5] Based on this adjustment, respondent reduced the estate's tax deficiency to $16,326,408 and the accuracy-related penalty to $6,530,563.

OPINION

Generally, under section 2031(a) the value of a decedent's gross estate is based on the fair market value of property owned by the decedent on the date of death. For Federal estate tax purposes, the term "fair market value" is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. *United States v. Cartwright,* 411 U.S. 546, 551, 93 S.Ct. 1713, 36 L.Ed.2d 528 (1973); sec. 20.2031-1(b), Estate Tax Regs.

With regard particularly to unlisted, closely held stock in corporations such as TPC (with regard to which no bid and asked prices or other arm's-length sales information is available), the statutory language of section 2031 provides that the value of stock in comparable public corporations shall be taken into account. Section 2031(b) provides—

> In the case of stock and securities of a corporation the value of which * * * cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.

In utilizing, however, public companies to estimate the value of private, closely held companies, care must be taken to ensure that the public companies

used are sufficiently comparable to the private companies being valued. In this regard, Rev. Rul. 59-60, 1959-1 C.B. 237, 242, cautions as follows:

> Although the only restrictive requirement as to comparable corporations specified in the statute [sec. 2031(b)] is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. * * *

Courts recognize that a comparable company valuation may be rejected where the companies relied on are not sufficiently similar to the company being valued. In *Estate of Jung v. Commissioner,* 101 T.C. 412, 433, 1993 WL 460544 (1993), significant differences between the companies used as comparables and the company being valued caused the Court to reject the comparable public company method. In *Estate of Klauss v. Commissioner,* T.C. Memo. 2000-191, an expert's comparability analysis was found to be inadequate because the expert failed to take into account differences in size, product mix, customer concentration, and other factors between the companies used as comparables and the company being valued.

With regard to "the other factors" referred to in section 2031(b) to be taken into account in the valuation of private, closely held companies, section 20.2031-2(f), Estate Tax Regs., explains, in part, as follows:

> (f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and

asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

> (2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" * * * are: the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. * * *

Rev. Rul. 59-60, 1959-1 C.B. 237, 238-239, lists eight factors that are particularly relevant to the fair market value of stock of closely held companies as follows:

> (1) The nature of the business and the history of the enterprise;
>
> (2) The general economic outlook and the particular outlook for the specific industry;
>
> (3) The financial condition of the business and its book value;
>
> (4) The earning capacity of the company;

(5) The dividend-paying capacity of the company;

(6) The value of any intangible assets and goodwill;

(7) Previous sales of the stock and the size of the interest to be valued; and

(8) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60, *supra*, acknowledges that a valuation of closely held stock is not an exact science, but rather involves a question of fact. In this regard, Rev. Rul. 59-60, states—

> A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. [1959-1 C.B. 237, 238.]

As noted, although in valuing the fair market value of corporate stock the future prospects of a company are relevant, generally an appraisal of fair market value is made without regard to actual subsequent-year events (i.e., to actual events occurring after the relevant valuation date). *Krapf v. United States*, 977 F.2d 1454, 1458 (Fed. Cir. 1992).

The authorities allow, however, that in a number of situations subsequent-year events may be considered. For example, actual subsequent-year events may be considered where such "evidence

would make more or less probable the proposition that the property had a certain fair market value on a given date". *First Natl. Bank of Kenosha v. United States,* 763 F.2d 891, 894 (7th Cir. 1985). Subsequent-year events may be considered where they are "reasonably foreseeable", *Saltzman v. Commissioner,* 131 F.3d 87, 93 (2d Cir. 1997), revg. T.C. Memo. 1994-641, or "corroborate an appraisal that is based on facts known as of the valuation date", *Jacobson v. Commissioner,* T.C. Memo. 1989-606. Further, subsequent-year events may be admissible where relevant as to whether asserted expectations or prospects (as of the valuation date) were "reasonable and intelligent." *Estate of Gilford v. Commissioner,* 88 T.C. 38, 54, 1987 WL 49260 (1987); *Estate of Jephson v. Commissioner,* 81 T.C. 999, 1002, 1983 WL 14908 (1983); *Regents Park Partners v. Commissioner,* T.C. Memo. 1992-336.

As explained, in the case herein, for Federal estate tax purposes, both parties relied on valuation reports to estimate the date-of-death value of the estate's 20-percent interest in TPC. The estate's experts valued decedent's interest in TPC at approximately $1.750 million. Respondent's expert valued decedent's interest at approximately $32.4 million. The large disparity between the parties' valuations is startling.

Where conflicting valuations are submitted, a court may give different weight to the valuations and factors relied on by the parties. *Casey v. Commissioner,* 38 T.C. 357, 381, 1962 WL 1092 (1962). The Court is not bound to adopt either party's valuation carte blanche and is to reach a decision based on its analysis and its consideration of the evidence. *Helvering v. Natl. Grocery Co.,* 304 U.S. 282, 295, 58 S.Ct. 932, 82 L.Ed. 1346 (1938); *McCord*

v. Commissioner 120 T.C. 358, 374, 2003 WL 21089049 (2003); *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 217, 1990 WL 17251 (1990).[6]

In this case, the estate's experts impress us as too inexperienced, accommodating, and biased in favor of the estate.

Respondent's expert appears to have selected his comparable companies in a casual manner, based only on broad industry classification factors. He made significant errors in his calculations and analysis, and he made questionable and inadequately explained adjustments in his discounted cashflow valuation method.

The Estate's Valuation

As stated, in their original and revised valuation reports the estate's experts from Alaska calculated a total date-of-death value of $1,749,709 ($3.59 per share) for the estate's 20-percent common stock interest in TPC. In arriving at this number, the estate's experts concluded that no companies existed

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[6] Under sec. 7491, where a taxpayer produces credible evidence and otherwise satisfies the requirements of sec. 7491(a)(2), the burden of proof with respect to a factual issue relevant to ascertaining the taxpayer's tax liability (such as the fair market value of property) may shift from the taxpayer to respondent. Herein, in preparation for trial, the parties stipulated that the estate satisfied the requirements set forth in sec. 7491(a)(2). At trial, we determined that for purposes of sec. 7491(a)(1), the evidence produced by the estate as to the valuation of the TPC stock was to be treated as credible evidence. Therefore, respondent has the burden of proof with regard to the valuation of the estate's 20-percent stock interest in TPC.

that were comparable to TPC, and they valued TPC as an entity using the capitalization of income method.

In capitalizing the income of TPC, however, the estate's experts significantly downplayed TPC's long history of substantial income. They misstated certain financial data,[7] and they opined that TPC's business would be heavily and adversely impacted by the Internet and by other advances in technology, even though the estate's experts demonstrated no experience with the Internet-and technology-related companies.

Under the capitalization of income valuation method, a business is valued based on a projected stream of "normalized" or sustainable income, capitalized by a risk-adjusted rate of return. The basic steps involved in the capitalization of income method are as follows:

(1) A capitalization rate for the business is selected;

(2) The business's sustainable income is projected;

(3) The capitalization rate is applied to the projected sustainable income for the business to calculate an operating value for the business; and

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[7] For example, in their original report, the estate's experts stated that TPC's growth in revenue for years subsequent to 1994 was flat, contrary to the fact that TPC's revenue reached record levels in each of the years 1994-99.

(4) The amount or value of nonoperating assets owned by the business is added to the operating value of the business.

Obviously, the particular capitalization rate that is selected has a significant impact on the ultimate valuation and is intended to reflect risks or volatility associated with a company's income stream and seeks to reflect what a stockholder would require for a rate of return on an investment in the company being valued. The more risky and volatile the income stream is perceived to be, the higher the capitalization rate. Conversely, the more stable the income stream is perceived to be, the lower the capitalization rate.

In this case, the estate's experts calculated a capitalization rate of 30.5 percent for TPC. This capitalization rate was calculated by the estate's experts by adding together the following risk factors and percentages:

(1) 6 percent to reflect a risk-free rate of return (equal to the May 1, 1998, yield on 20-year U.S. Treasury securities);

(2) 7.8 percent to reflect an equity-risk premium (to compensate an investor for the risk of investing in stocks as compared to long-term U.S. government securities, reflecting the percentage by which the average annual return on large corporate stocks exceeds the average annual return on U.S. government securities, as provided in the Ibbotson Associates' *Stocks, Bonds, Bills & Inflation Yearbook* for the years 1926-97);

(3) 4.7 percent to reflect a small stock risk (to compensate an investor for the risk of investing in stock of a small corporation as compared to a large corporation, reflecting the percentage by which the average annual return earned on small corporate stock exceeds the average annual return on large corporate stock, as provided in the Ibbotson Associates' *Stocks, Bonds, Bills & Inflation Yearbook* for the years 1926-97); and

(4) 12 percent primarily to reflect risks to TPC relating to the Internet and to technology and to the loss of advertising revenue that might be related thereto, including perceived risks in TPC's management structure.

The 30.5-percent capitalization rate used by the estate's experts in the valuation of TPC stock is summarized below:

Risk Factors	Percentage
Risk-Free Rate of Return	6.0
Corporate Equity Risk	7.8
Small Stock Risk	4.7
Internet & Management Risk	12.0
Capitalization Rate	30.5

In estimating TPC's sustainable annual net income against which to apply the above capitalization rate, the experts for the estate adjusted TPC's historical income statements for 1993-97 as follows:

(1) Based on projections of TPC management, $10 million per year was subtracted from TPC's pretax income to reflect projected additional expenditures to maintain and to further TPC's presence on the Internet, and to develop additional technology-related projects; and

(2) Because TPC purportedly depreciated its fixed assets at a slower rate than the assets' actual rate of economic depreciation, the experts for the estate subtracted an amount to reflect the cost of additional economic depreciation to fixed assets not booked each year by TPC.

The adjustments made by the estate's experts to TPC's historic pretax income for 1993-97 are summarized below:[8]

(table on page A-51)

In order to then calculate an after-tax average sustainable annual net income for TPC, using the above adjusted pretax income figures for 1993-97, the estate's experts made the following calculations:

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[8] In this and the following tables, generally, the numbers are rounded to the nearest thousand.

	1993	1994	1995	1996	1997
Reported Pretax Income	$24,902,000	$22,152,000	$18,737,000	$23,057,000	$26,921,000
Less Technology Expenditures	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Less Additional Depreciation	1,340,000	756,000	920,000	1,183,000	1,078,000
Adjusted Pretax Income	$13,562,000	$11,396,000	$7,817,000	$11,874,000	$15,843,000

Year	Adjusted Pretax Income
1993	$13,562,000
1994	11,396,000
1995	7,817,000
1996	11,874,000
1997	15,843,000
Total Adj. Pretax Income for 5 Years	$60,492,000
Divided by Number of Years	5
TPC Average Annual Sustainable Net Income	12,098,000
Less 35% Taxes	4,234,000
TPC After-Tax Average Sustainable Annual Net Income	$7,864,000

The experts for the estate then applied their 30-percent capitalization rate for TPC to their $7,864,000 after-tax average sustainable annual net income for TPC and thereby calculated a value for TPC of $25,784,000 ($7,864,000 / .305 = $25,784,000).

After calculating the above $25,784,000 entity value for TPC, the estate's experts calculated a prediscounted value for the estate's 20-percent interest in TPC as follows:

Value of TPC	$25,784,000
Multiplied by Estate's 20.57% Interest	.2057
Prediscounted Value of Estate's Interest	$5,304,000

The estate's experts then discounted the above $5,304,000 by applying a 40-percent minority interest discount and an additional 45-percent lack of marketability discount to arrive at a date-of-death value of $1,750,000 for the 487,440 shares of TPC common stock includable in decedent's estate, as summarized below:

Prediscounted Value of Estate's 20.57% Interest	$5,304,000
Less 40% Minority Interest Discount	2,122,000
Subtotal	$3,182,000
Less 45% Lack of Marketability Discount	1,432,000
Value of Estate's 20.57% TPC Stock Interest	$1,750,000

The estate's experts' 40-percent minority interest discount was based primarily on their reading of general valuation texts.[9]

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[9] Coolidge, "Survey Shows Trend Toward Larger Minority Discounts", Estate Planning 282 (Sept. 1983); Coolidge, "Fixing Value of Minority Interest in a Business; Actual Sales Suggest Discount as High as 70%", Estate Planning 141 (Spring 1975).

The estate's experts' 45-percent lack of marketability discount was based largely on the following factors: (1) The stated intent of TPC's management that it had no interest in going public; (2) the absence of sales of TPC stock for the 10 years prior to May 2, 1998; (3) the inability of any stockholder of TPC to obtain control of TPC by purchasing merely the estate's 20-percent interest; and (4) the inability of the holder of the estate's block of TPC stock to force a liquidation of TPC.

The estate's experts, however, provided no credible explanation for why they used 40-percent and 45-percent minority interest and lack of marketability discounts, as distinguished from some other numbers — e.g., 20 percent or 30 percent.

Respondent's Valuation

Respondent's expert estimated a date-of-death fair market value for TPC of $225 million and a date-of-death fair market value for the estate's 20-percent TPC stock interest of $32.4 million. Respondent's expert utilized two valuation methods to value TPC-the comparable public company method and the discounted cashflow method. In his revised report, in the process of making certain corrections to errors made in his original report, respondent's expert made significant questionable adjustments in his discounted cashflow method that are inconsistent with the methodology utilized in his original report. In his original and revised reports respondent's expert did not utilize the capitalization of income method.

Using the comparable public company method, respondent's expert identified 11 publicly traded companies and treated them as comparable to TPC on the basis of only two broad criteria as follows:

(1) Classification under the same general U.S. Department of Labor Standard Industrial Codes as TPC (namely, Code # 2731-Books: Publishing, or Publishing and Printing, and Code # 2741-Miscellaneous Publishing); and

(2) Reported positive cashflows for 1995-97.

Set forth below in schedule format is a listing of TPC and the 11 companies selected by respondent's expert as comparable to TPC, a brief description of the primary type of content material which each company, as of July 31, 2000, published, and the amount of each company's 1997 reported revenue:

(table on pages A-56–57)

From publicly reported financial information relating to the above public companies, respondent's expert calculated four financial measurement ratios applicable to each company-namely, stock price to net income, stock price to cashflow, stock market value to book value of tangible and intangible assets, and stock price to revenue.

Applying the ratios so calculated to the 11 companies, respondent's expert calculated the median ratio for each measurement, and he applied that respective median ratio as a multiple to TPC's 5-year (1993-97) average annual net income, cashflow, book value, and revenue as follows:

(table on page A-58)

Company	Publication Material	1997 Revenue
TPC	Industrial buying directories	$240,110,000
American Educational Products	Educational textbooks, journals, and games	8,392,000
Harcourt General, Inc.	Scholarly books and journals, educational material, popular books. Owns the Neiman Marcus Group, Inc.	3,691,639,000
Houghton Mifflin Co.	Textbooks and educational reference materials	797,320,000
Intervisual Books, Inc.	Popup and dimensional novelty books	18,733,000
McGraw-Hill Co.	Educational books and magazines. Owns Standard & Poor's and four television stations	3,534,095,000
Millbrook Press, Inc.	Children's nonfiction books	12,573,000

(Table Continued on Page A-57)

Company	Publication Material	1997 Revenue
Nelson (Thomas), Inc.	Religious and family value books	243,436,000
Readers Digest Association	Magazines, and educational, condensed, and popular books, recorded music collections, and home videos	2,839,000,000
Scholastic Corp.	Children's books and classroom and professional magazines	966,300,000
Touchstone Applied Science Associates	Reading and English testing materials	4,588,000
Wiley (John) & Sons	Professional and reference works, consumer books, and textbooks	431,947,000

	Net Income	Cashflow	Book Value	Revenue
TPC 5-Year Average	$13,259,000	$15,187,000	$148,606,000	$235,995,000
Multiple Based on Median Ratio For 11 Public Companies	25.9	14.3	2.5	1.04
Total for TPC	$343,659,000	$216,780,000	$364,787,000	$245,681,000

Using the $216,780,000 (rounded to $217 million) calculated above for the cashflow ratio (apparently because the cashflow ratio was the most consistent measurement ratio as between the 11 companies), respondent's expert adjusted upward this $217 million to take into account the higher valuation amounts reflected by the other measurement ratios, and he calculated a total value for TPC under his comparable public company method of $260 million.

As stated, in both his original report and in his revised report, respondent's expert also valued TPC using the discounted cashflow method. Thereunder, using TPC's 1997 reported income, respondent's expert calculated a 2.7-percent annual income growth rate (in his original report) and a 2.4-percent annual income growth rate (in his revised report), which growth rates he applied to TPC's actual net cashflow for 1997 to estimate TPC's net cashflow for the subsequent 5 years (1998-2002).

As explained *supra,* however, in his original report, for TPC's 1997 net cashflow number, respondent's expert used $13,069,000. This number was incorrect and was significantly overstated because respondent's expert added back to TPC's 1997 cashflow deferred taxes of $13,294,000, instead of the correct deferred tax add-back of only $1,609,793.[10]

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[10] In his revised report, in calculating TPC's 1997 net cashflow, respondent's expert used the corrected deferred tax add-back of $1,609,793. This correction resulted in a revised or new number for TPC's 1997 net cashflow of only $1,384,000.

To his estimated TPC net cashflow numbers for 1998-2002 (based on his calculation of TPC's $13,069,000 net 1997 cashflow), respondent's expert applied a discount rate to calculate a present value, as of May 2, 1998, of the estimated 1998-2002 net cashflow.

Respondent's expert's discount rate for each year was based on his estimate of TPC's cost of equity, calculated under the capital asset pricing model, and involved the following elements:

(1) A risk-free rate of return of 5.933 percent, equal to the U.S. government long-term bond rate as of May 2, 1998;

(2) A market-risk premium that varied to reflect the risk of investing in a private company and the perceived risks of investing in stocks rather than in long-term government bonds; and

(3) An estimate of unlevered beta for TPC of 0.60 to reflect the volatility or level of risk associated with TPC's stock as compared to the volatility of the stock market as a whole (where the market has an overall beta of 1).[11]

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[11] The discount rate which respondent's expert applied to TPC's estimated net cashflow for each year is set forth below:

Year	Percentage
1998	10.482
1999	9.855
2000	9.497
2001	9.246
2002	9.145

In his original report, respondent's expert also calculated and added to his present value calculations of TPC's estimated net cashflow for 1998-2002 a $153,174,000 estimate of TPC's residual value, based on a discounted "terminal value" for TPC. In the words of respondent's expert, this terminal value "incorporates all [estimated cash] flows [for TPC] after Fiscal 2002" discounted back to the end of 2002. With his discounted terminal value for TPC added to his present value calculation of TPC's estimated net cashflow for 1998-2002, respondent's expert concluded in his original report that TPC had a May 2, 1998, fair market value of $212.6 million as follows:

Fiscal Year	Present Value of Estimated Cashflows
1998	$13,141,000
1999	12,637,000
2000	11,884,000
2001	11,217,000
2002	10,579,000
Subtotal	$59,458,000
Plus Discounted Terminal Value	153,174,000
Valuation of TPC	$212,632,000

In his revised report, however, after adjusting his add-back to TPC's 1997 net cashflow for the corrected $1,609,793 deferred taxes (discussed *supra*) (which as indicated resulted in a greatly reduced calculation of TPC's estimated net cashflow number for 1998-2002), respondent's expert switched his residual value calculation for TPC after 2002 by estimating what he refers to as a $152,567,000

"liquidation" value for TPC. Respondent's expert's revised discounted cashflow calculation using the much reduced cashflow numbers but a liquidation (rather than a terminal) value for TPC is summarized below:

Fiscal Year	Present Value of Estimated Cashflows
1998	$1,390,000
1999	1,333,000
2000	1,251,000
2001	1,178,000
2002	1,108,000
Subtotal	$ 6,260,000
Plus Liquidation Value	152,567,000
Valuation of TPC	$158,827,000

In calculating the residual value for TPC to be added to his net cashflow projections for 1998-2002, respondent's expert's switch in his revised report from a terminal value to a liquidation value calculation appears to us to be an effort on the part of respondent's expert to keep the valuation for TPC relatively high.[12]

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[12] Generally, terminal value is used to compute an entity's residual value beyond the period for which an entity's net cashflows are projected, whereas liquidation value generally is used only when the entity being valued has plans to liquidate at the end of the projection period. Copeland, et al., Valuation 284 (3d ed. 2000) (providing that liquidation value should not be used "unless liquidation is likely at the end of the forecast period"). Here, TPC's management, as of May of 1998, had no plans to liquidate TPC. Using the correct $1.609 million in deferred tax add-back, the calculation under respondent's expert's discounted cashflow method using a terminal value

In his revised report, respondent's expert, apparently still not satisfied with his revised $158.8 million valuation for TPC (using the corrected deferred tax add-back and a liquidation value for TPC), goes on to recalculate much higher projected net cashflow numbers for TPC for 1998-2002, and he calculates three higher valuations for TPC.

The major aspect or component of respondent's expert's recalculation of TPC's projected net cashflows for 1998-2002 is his use of TPC's 1997 yearend total working capital, instead of TPC's 1997 change in net working capital. The effect of using yearend total working capital (against which his growth rate for TPC was applied) was to significantly increase TPC's estimated cashflow for 1998-2002 by approximately $12 million a year.

Based on the various calculations under his various methods, respondent's expert ultimately concluded that the total fair market value for TPC as an entity, as of May 2, 1998, was $225 million.

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calculation for TPC's 2002 residual value would have reflected a May 2, 1998, fair market value for TPC of only $21.7 million as follows:

Fiscal Year	Present Value of Estimated Cashflows
1998	$ 1,390,000
1999	1,333,000
2000	1,251,000
2001	1,178,000
2002	1,108,000
Subtotal	$ 6,260,000
Plus 2002 Terminal Value	15,415,372
Valuation of TPC	$21,675,372

To the estate's $46,282,500 20-percent share of this $225 million ($225,000,000 x .2057 = $46,282,500), respondent's expert applied a 30-percent lack of marketability discount and arrives at a date-of-death value of $32,393,000 for the estate's 20-percent stock interest in TPC.

Respondent's expert bases his 30-percent (as opposed to a higher) lack of marketability discount on the following: (1) TPC was not publicly traded; (2) historically, TPC was profitable; (3) investment risks associated with TPC were moderate; (4) TPC had consistently paid cash dividends; (5) as of May 2, 1998, TPC held more than $137 million in net liquid assets; and (6) the estate owned the single largest block of TPC stock. Respondent's expert's calculation of the $32,393,000 valuation for the estate's 20.57-percent stock interest in TPC may be summarized as follows:

Value of TPC	$225,000,000
Multiplied by Estate's Interest in TPC	20.57%
Prediscounted Value of Estate's Interest	$46,282,500
Less 30% Marketability Discount	13,884,750
Value of Estate's 20.57% Interest in TPC	$32,393,000*

* $32,393,000 represents the calculation as reflected in respondent's expert's revised report. The corrected math calculates to $32,397,750.

As indicated, respondent's expert does not apply a minority interest discount to the estate's 20-percent TPC stock interest. Rather, respondent's expert states that his discounted cashflow method of valuation inherently reflects a minority interest in TPC and therefore that no separate or additional minority interest discount is appropriate.

Our Analysis

As mentioned, we find both the estate's and respondent's valuations to be deficient and unpersuasive in calculating the fair market value of TPC as an entity and in calculating the fair market value of the estate's 20-percent interest therein.

In this case, the estate, the executors of the estate, and the underlying company, the stock of which is being valued, were all headquartered and based in the New York City metropolitan area, but the estate hired a lawyer and an accountant from Alaska, both with relatively little valuation experience, to value the estate's 20-percent interest in TPC. The estate's experts valued TPC and the estate's interest in TPC in an aggressive manner largely by over calculating as of the May 2, 1998, valuation date, the risks associated with the Internet and technology and by applying excessive minority and lack of marketability discounts.

Goerig is a lawyer with an audit and tax dispute resolution practice, and a tax return preparer, and he undertakes occasional valuations for small businesses and private individuals. From his resume, he appears to have attended limited appraisal courses, other than a few courses while working for respondent many years ago. Goerig also was appointed to act as administrator for the estate to

handle the anticipated audit by respondent of the estate's Federal estate tax return, a role which we regard as somewhat in tension with his role as a purported independent valuation expert for the estate.

Wichorek provides accounting and tax preparation services, does business consulting, and undertakes occasional valuations for small businesses, generally in the context of divorce and property settlement disputes. He belongs to no professional organizations or associations relating to his appraisal or valuation work.

Although we admitted into evidence the estate's valuation reports and treated them as credible, we regard those reports and the testimony of the estate's experts to be only marginally credible. Goerig and Wichorek were barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars.[13]

In our opinion, in computing the sustainable net income of TPC, the estate's experts incorrectly applied a 12-percent risk factor relating to the Internet and technology. We acknowledge that while the Internet posed certain risks to TPC, the Internet also provided significant new business and financial opportunities to TPC to increase revenue and profitability. As of May 2, 1998, TPC appeared to be

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[13] At trial, the estate called additional expert witnesses in an attempt to provide corroboration for aspects of the valuation of TPC and of the estate's interest in TPC by Goerig and Wichorek. Such witnesses, however, have not cured the concerns we have with Goerig's and Wichorek's valuation of TPC and of the estate's interest therein.

well situated on the Internet, and TPC's future as to its Internet operations appeared good, if not, in the words of TPC's president, "great". As stated in the estate's experts' report, as of May of 1998, TPC "appears to be in a strong overall financial position when compared to the industry. [TPC] has more liquidity, no leverage, and operates more profitably than the median industry. Based on the financial analyses of [TPC], the business has less financial risk than does the median company in the same industry."

The use by the estate's experts of a 12-percent technology-related risk factor, particularly in light of their failure to project any additional income to be produced from technology-related expenditures, seems to us inappropriate and unjustified.

Supporting our conclusion that TPC's risks relating to the Internet and technology do not support a 12-percent risk factor, we note that, during its 1998 fiscal year, TPC paid out cash dividends to its stockholders in excess of $7 million, a significant increase over total cash dividends paid out to stockholders in prior years and inconsistent with any management perception that, as of May of 1998, or in the near future, TPC faced extraordinarily risky additional Internet- and technology-related expenditures.

TPC's 1998 cash dividends, particularly in light of the lower level of stockholder dividends that had been paid in prior years, are indicative of an optimistic management outlook for TPC as of May of 1998.

As explained by TPC's president, although its profitability margins and net income were declining due to increased spending on technology-related projects, in 1997 and 1998 TPC experienced record revenue. Not until 2001 was TPC's total revenue adversely affected in a significant way by the Internet and by new technology. Mr. Holst-Knudsen explained at trial as follows:

> Q. [By petitioner's counsel] When, if at all, did [TPC] take what you've termed a "hit"?
>
> A. We were taking a hit in the sense of, as I said before, the investments we were making. That hit became more serious as we went on. I would say that the years 2001, 2002, and the fiscal year that will close this year is when we really began to take the hit on our top line, on revenues. We have shed approximately 30 percent of our revenue, and about 35 to 40 percent of our account basis disappeared over that period of time.

The additional $10 million a year in technology-related expenditures that the estate's experts factored into their projections of subsequent-year income, and that we also allow, we believe to be an adequate indication or quantification of the level of Internet- and technology-related risks TPC faced, as of May 2, 1998.

Also, we regard TPC as an extremely well managed company, with top quality managers throughout the company. We allow no separate risk factor for what the estate's experts refer to as management risk.

Respondent asserts that the estate's $25 million valuation for TPC as an entity (and $1.7 million for the estate's 20-percent interest therein) is absurd in light of TPC's 1997 fiscal yearend book value in the range of $148 million. Respondent also asserts that if we utilize the capitalization of income method to value TPC (as did the estate's experts and as we do), we should take the cash and short-term liquid assets from TPC's balance sheet, treat them as nonoperating assets, and add them to any calculation of the capitalized income of TPC that we make.

From the end of its 1993 fiscal year through the end of its 1997 fiscal year, TPC's cash and outside short-term (more than 3-month) investments reported on its yearend balance sheets increased from $42.3 million to $73.6 million. Throughout the 1990s, TPC increased its short-term liquid investments and still paid significant cash dividends to its stockholders. Not until its 2000 fiscal year does TPC's yearend balance sheet reflect any significant reduction in outside short-term investments.

On each of TPC's 1997 and 1998 fiscal yearend balance sheets, approximately $68 million is shown as outside short-term investments with an investment term of more than 3 months. We treat these $68 million in short-term liquid investments as nonoperating assets to be added to the valuation of TPC under a capitalization of income valuation method. We are not persuaded that these liquid

investments should be treated as operating assets due to TPC's commitment to advance sales commissions.[14]

TPC's yearend cash on hand, however, is not to be treated as anything other than an operating asset and is not to be treated as an add-on in the calculation of TPC's value under the capitalization of income method.

As to the valuation of the particular 20-percent block of TPC stock includable in the estate, we disagree with the large minority (45-percent) and lack of marketability (40-percent) discounts utilized by the estate's experts in calculating the fair market value of the estate's 20-percent TPC stock interest.

As noted, the estate's experts based their minority and lack of marketability discounts on general studies and not on the facts of this case. The experts for the estate selected discount rates that were extreme and highly favorable for the estate, without any credible substantive discussion of how the facts of this case support such particular discounts.

Also, as we have noted, as of May of 1998, at least one outside, public investor owned and had owned for at least 10 years a substantial TPC stock interest. The evidence before us does not suggest any problem, discontent, dissatisfaction, or other concern with the presence of this outside stockholder. The longstanding stock interest of this actual outside investor in TPC suggests that a hypothetical outside

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[14] In our calculation of prior year TPC income, we also add-back additional depreciation that the estate's experts add-back and that respondent apparently does not dispute.

investor would be interested in an investment in TPC in the nature of the minority 20-percent stock interest held by the estate.

We reject the minority and lack of marketability discounts used by the estate's experts.

Turning to respondent's expert's valuation, respondent's expert appeared to be concerned with numbers only and did not appear to make an effort to base his valuation of TPC on a real company. His sterile approach is reflected both in his comparable public company analysis and in his discounted cashflow analysis.

In his comparable public company analysis, respondent's expert used information on 11 companies which, only in a broad sense, relate to TPC. Valuation of a company under a comparable public company method may be simple and quick, but such an approach also may be easily misapplied. With regard to this concern, valuation textbooks caution:

> The allure of multiples is that they are simple and easy to relate to. * * *
>
> By the same token, they are also easy to misuse and manipulate, especially when comparable firms are used. Given that no two firms are exactly similar in terms of risk and growth, the definition of comparable firm is a subjective one. Consequently a biased analyst can choose a group of comparable firms to confirm his or her biases about a firm's value * * *. [Damodaran, Damodaran on Valuation 16 (1994).]

> and further: Since the selection of comparable firms has such a paramount role in valuation with multiples, special attention must be paid to selecting a true comparable sample of firms-firms that are in the same industry, employ the same technology, apply to similar clienteles, are of similar size, and so on. * * * [Benninga & Sarig, Corporate Finance A Valuation Approach 330 (1997).]

We reject respondent's expert's 11 companies as comparable to TPC. See *Estate of Clarke v. Commissioner*, T.C. Memo. 1976-328, where we rejected public companies as comparable, explaining as follows:

> the fact that two companies are both part of the same general industry does not, as respondent's expert implies, make them comparable per se. Such a standard clearly ignores the interplay of the myriad of complex factors and features that must be accounted for in any meaningful comparison. Rather we think it imperative that the characteristics of the subject company and the purportedly comparable company relevant to the question of value be isolated and examined so that a *significant comparison* can be made. Those factors include the respective products, market, management, earnings, dividend paying capacity, book value, and position in the industry of each company. See *Cent. Trust Co. v. United States*, 158 Ct.Cl. 504, 305 F.2d 393 (Ct. Cl. 1962). [Emphasis added.]

Also, we reject respondent's expert's discounted cashflow analysis. As explained, significant errors were made therein, and respondent's expert's numerous recalculations were suspect, not sufficiently explained, and not persuasive.

Also, we disagree with respondent's expert that no discount should be applied to the estate's 20-percent interest to reflect its minority status. In cases cited just in the parties' briefs, the following minority discounts are observed: 25 percent-*N. Trust Co. v. Commissioner*, 87 T.C. 349, 389, 1986 WL 22171 (1986); 10 percent-*Estate of Heck v. Commissioner*, T.C. Memo. 2002-34; 15 percent and 20 percent-*Gow v. Commissioner*, T.C. Memo. 2000-93, affd. 19 Fed. Appx. 90 (4th Cir. 2001).

In cases cited in the parties' briefs, the following lack of marketability discounts are observed: 20 percent — *N. Trust Co. v. Commissioner, supra* at 389; 30 percent — *Estate of Desmond v. Commissioner*, T.C. Memo. 1999-76; 40 percent and 45 percent — *Barnes v. Commissioner*, T.C. Memo. 1998-413; 30 percent — *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, affd. without published opinion 91 F.3d 124 (3d Cir. 1996); 30 percent — *Estate of Gallo v. Commissioner*, T.C. Memo. 1985-363.

On the evidence before us in this case, we conclude that the appropriate valuation of the estate's 20-percent stock interest in TPC, as of May 2, 1998, should be based on a capitalization of TPC's estimated sustainable net income for 1998-2002 calculated as an average of TPC's 1993-97 income with an additional $10 million per year in expenditures relating to projected Internet-and technology-

related expenditures. The 30.5-percent capitalization rate used by the estate's experts should be reduced by 12 percent, from 30.5 percent to 18.5 percent, to better reflect our belief that the Internet, as of May 2, 1998, constituted a factor for TPC almost as positive as it was negative. Also, $68 million of nonoperating assets should be added.

Our calculation of the appropriate 18.5-percent capitalization rate is as follows:

Risk Factors	Percentage
Risk-Free Rate of Return	6.0
Corporate Equity Risk	7.8
Small Stock Risk	4.7*
Internet & Management Risk	0.0
Capitalization Rate	18.5

In discounting to reflect the estate's minority 20-percent interest in TPC, we allow a 15-percent minority interest discount and a 30-percent lack of marketability discount. We scale back the minority and lack of marketability discounts from those used by the estate's experts because, as noted above, we find the estate's experts' numbers to be arbitrary and without support.

We believe a minority interest discount of 15 percent is a better reflection of the estate's 20-percent common stock interest in TPC. Although a minority interest, the holder of such interest would own the single largest block of stock in TPC, a major,

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* We note that, in spite of the size of TPC, respondent did not discretely challenge this small stock discount.

well-established, well-run company with relatively few stockholders, in which a longstanding outside investor is already present and apparently content.

With regard to the lack of marketability discount, we believe a 30-percent lack of marketability discount adequately reflects difficulties the estate and a hypothetical investor might have in marketing the estate's 20-percent TPC stock interest. Indeed, but for the fact that respondent's expert allowed a 30-percent discount for lack of marketability, we might have been inclined to reduce this discount. A discount any higher would not appear to be justified, particularly in light of the presence among TPC's stockholders of a significant outsider stockholder who already owns a relatively large, minority block of TPC stock. We also note the dividend-paying history of TPC, and TPC's plans, as of May of 1998, to continue its practice of paying substantial cash dividends, which subsequent-year dividends would allow a holder of a 20-percent interest in TPC to recover annually, based on prior-year dividends paid, in excess of one quarter of a million dollars.

We conclude that the date-of-death value of TPC as an entity, as of May 2, 1998, is $110,508,000 and that the date-of-death value of the estate's 20.57-percent interest in TPC is $13,525,240, or $27.75 per share.

Our calculation of the fair market value of TPC as an entity and of the estate's 20.57-percent interest in TPC is set forth below:

Capitalization Rate	18.5%
Minority Discount	15%
Marketability Discount	30%
TPC's Sustainable Net Income	
Year	Pretax Income
1993	$13,562,000
1994	11,396,000
1995	7,817,000
1996	11,874,000
1997	15,843,000
Total Pretax Income	$60,492,000
Divided by Number of Years	5
Average Pretax Income	$12,098,000
Less Estimated 35% Taxes	(4,234,000)
Sustainable Net Income	$7,864,000
Divided by Capitalization Rate	18.5%
Subtotal	$42,508,000
Plus Nonoperating Assets	68,000,000
Value of TPC	$110,508,000
Value of Estate's 20-Percent Stock Interest	
Value of TPC	$110,508,000
Multiplied by Estate's Percent Interest	20.57%
Subtotal	$22,731,496
Less 15% Minority Discount	3,409,724

Subtotal	$19,321,771
Less 30% Marketability Discount	5,796,531
Value of Estate's 20% TPC Interest	$13,525,240
Per-Share Value	$27.75

Taking into account all of the evidence before us and the arguments of the parties, we believe that our above valuation constitutes a fair and appropriate valuation of TPC and of the estate's interest in TPC.

Accuracy-Related Penalty

Generally, a 20-percent penalty is imposed on "any portion of an underpayment of tax required to be shown on a return" where the underpayment constitutes a substantial estate tax valuation understatement. Sec. 6662(a) and (b)(5).

For purposes of section 6662, an estate tax valuation understatement is treated as substantial where property required to be reported on an estate tax return is reported at a value 50 percent or less than the value eventually determined by the court. Sec. 6662(g)(1). Where property is reported at a value less than 25 percent of the value eventually determined by the court, the penalty imposed under section 6662 is increased from 20 percent to 40 percent. Sec. 6662(h).

We have determined the value of the estate's 20-percent interest in TPC to be $13,525,240. Because the value reported by the estate for its 20-percent interest in TPC ($1.8 million) is less than 25 percent of the value determined herein ($13,525,240 x .25 = $3,381,310), unless an exception to the application of

the section 6662 penalty applies, the estate would be liable for a 40-percent penalty on its understated valuation.

Under section 6664, an exception is provided to the imposition of a section 6662 accuracy-related penalty where a taxpayer establishes that there was reasonable cause for the understatement and that the taxpayer acted in good faith. Sec. 6664(c).

The regulations provide that whether an understatement of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Sec. 1.6664-4(b), Income Tax Regs. In determining whether a taxpayer acted reasonably and in good faith with regard to the valuation of property, factors to be considered include: (1) Whether the value reported on the tax return was based on an appraisal; (2) the methodology and assumptions underlying the appraisal; (3) the appraised value; (4) the circumstances under which the appraisal was obtained; and (5) the appraiser's relationship to the taxpayer. Sec. 1.6664-4(b)(1), Income Tax Regs.

The estate contends that it acted reasonably and in good faith in the valuation of the estate's 20-percent TPC stock interest, in filing its Federal estate tax return, and in reporting thereon the value of the TPC stock.

The valuation herein of the estate's 20-percent stock interest in TPC was particularly difficult and unique. Companies comparable to TPC were not found. Valuation of the estate's 20-percent TPC stock interest under the capitalization of income and under the discounted cashflow methods involved a number of difficult judgment calls. We believe it noteworthy

and relevant to the appropriateness of the section 6662 penalty that even respondent's expert made significant errors in his various calculations.

Complicating the valuation presented to the parties and to the Court herein was the difficult question as to how the Internet and the risks and opportunities associated therewith should be regarded as affecting TPC. The evaluation in this case of such intangible risks and opportunities was difficult and imprecise.

Certainly, the experts for the estate were aggressive in their relatively low valuation of TPC. Respondent's expert was aggressive in his relatively high valuation of TPC. We note that our valuation of TPC and of the estate's 20-percent interest in TPC is closer to the estate's valuation than to respondent's valuation.

On the record before us, we believe it inappropriate to impose the accuracy-related penalty. The estate is not liable for the accuracy-related penalty.

Accordingly,

Decision will be entered under Rule 155.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Catherine O'Hagan Wolfe
CLERK OF COURT

UNITED STATES COURT OF APPEALS
FILED
NOV 14 2007
Catherine O'Hagan Wolfe, Clerk
SECOND CIRCUIT

Date: Docket 06-0815-ag
06-1132-ag (CON)

Short Title: Estate of Josephine T. Thompson v. Commissioner of

Agency Number: 4939-02

Agency: Tax Court, Internal Revenue Service

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the day of November, two thousand seven.

Estate of Josephine T. Thompson, Deceased, Carl T. Holst-Knudsen, & The Bank of New York, Executors, Petitioner-Appellant-Cross-Appellees, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant.	Docket Nos. 06-0815-ag (Lead), 06-1132-ag (XAP)

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant-cross-appellees Estate of Josephine T. Thompson, Carl T. Holst-Knudsen, & The Bank of New York. Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED.**

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court:

Catherine O'Hagan Wolfe, Clerk

By: /s/
Motion Staff Attorney

Robert H. Goldie, Esq.
Satterlee, Stephens, Burke & Burke LLP
230 Park Ave.
New York, NY 10169

26 U.S.C.A. § 7491
I.R.C. § 7491

Effective: October 21, 1998

United States Code Annotated Currentness
Title 26. Internal Revenue Code (Refs & Annos)
Subtitle F. Procedure and Administration (Refs & Annos)
Chapter 76. Judicial Proceedings
Subchapter E. Burden of Proof

§ 7491. Burden of proof

(a) Burden shifts where taxpayer produces credible evidence. —

(1) General rule. — If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

(2) Limitations. — Paragraph (1) shall apply with respect to an issue only if —

(A) the taxpayer has complied with the requirements under this title to substantiate any item;

(B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and

(C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).

Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).

(3) Coordination. — Paragraph (1) shall not apply to any issue if any other provision of this title provides for a specific burden of proof with respect to such issue.

(b) Use of statistical information on unrelated taxpayers. — In the case of an individual taxpayer, the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

(c) Penalties. — Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

CREDIT(S)

(Added Pub.L. 105-206, Title III, § 3001(a), July 22, 1998, 112 Stat. 726, and amended Pub.L. 105-277, Div. J, Title IV, § 4002(b), Oct. 21, 1998, 112 Stat. 2681-906.)

Section 3001(c) of Pub.L. 105-206 provided that:

"**(1) In general.** — The amendments made by this section [enacting this section] shall apply to court proceedings arising in connection with examinations

commencing after the date of the enactment of this Act [July 22, 1998].

"(2) **Taxable periods or events after date of enactment.** — In any case in which there is no examination, such amendments shall apply to court proceedings arising in connection with taxable periods or events beginning or occurring after such date of enactment [July 22, 1998]."

Current through P.L. 110-180 (excluding P.L. 110-161 and 110-172) approved 1-8-08

APPEALTECH

205 Lexington Avenue, 10th Floor
New York, New York 10016
(212) 213-3222
{14013}

May 16 08

No. 07-1061

In the Supreme Court of the United States

ESTATE OF JOSEPHINE T. THOMPSON, DECEASED, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

PAUL D. CLEMENT
Solicitor General
Counsel of Record
NATHAN J. HOCHMAN
Assistant Attorney General
RICHARD FARBER
STEVEN W. PARKS
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Whether, after concluding that the Commissioner bears the burden of proof under 26 U.S.C. 7491, and rejecting the valuation of property proposed by the Commissioner, the Tax Court is required to accept the valuation proposed by the taxpayer's expert even if the court concludes that the valuation is contradicted by other record evidence.

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In the Supreme Court of the United States

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ESTATE OF JOSEPHINE T. THOMPSON, DECEASED, ET AL., PETITIONERS

v.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A13) is reported at 499 F.3d 129. The opinion of the Tax Court (Pet. App. A17-A79) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 23, 2007. A petition for rehearing was denied on November 14, 2007 (Pet. App. A81-A82). The petition for a writ of certiorari was filed on February 12, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. When Josephine T. Thompson died on May 2, 1998, she owned approximately 20% (487,440 shares) of

the stock of Thompson Publishing Company, Inc. (TPC). TPC, which was privately owned and closely held, published and sold business-to-business directories. TPC's stock had never been publicly traded, and there were no sales of the stock in the 10 years before Thompson's death. Pet. App. A2-A3, A17.

TPC described itself as "the acknowledged leader" in its field, having "by far the most complete and helpful specifying and buying guide published today." Pet. App. A21-A22 (quoting 22 *Thomas Register of American Manufacturers* 3573 (86th ed. 1996)). When Thompson died, TPC was regarded by some as holding an effective monopoly in the United States on business-to-business industrial and manufacturing print publications. *Id.* at A20-A21.

In 1993, TPC began offering business-to-business directories on CD-ROM. In 1995, TPC began making its directories available on the Internet. Pet. App. A3. TPC's management stated that its objective was "to secur[e] * * * a dominant position in the electronic interchange of information among industrial buyers and sellers comparable to that which it has enjoyed in the hard copy realm." *Id.* at A24; C.A. E.A. E648.[1] In 1997, TPC's president described its Internet activities as a "substantial success." *Id.* at E1087. By early 1998, TPC's web site was ranked sixth among business-to-business web sites in the United States. *Id.* at E975; Pet. App. A3.

Because of TPC's increasing focus on technology, between 1993 and 1997, the number of subscribers to its print products declined from 73,500 to 67,500, but the number of subscribers to its electronic products soared

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[1] The exhibit appendix in the court of appeals is cited as "C.A. E.A."

from 1000 to 575,000. Pet. App. A25-A26; C.A. E.A. E925. Similarly, between 1993 and 1998, TPC's subscription revenues fell from $14.9 million to approximately $14.1 million, but its advertising revenue, which was its primary revenue source, increased from $165 million to $258 million. Pet. App. A26-A27; C.A. E.A. E370, E407, E451, E519, E917-E918.

TPC had no long-term debt, and its net book value at the end of 1997 was approximately $150 million, almost all of which consisted of current assets, including a large portfolio of liquid short-term investments. Pet. App. A35, C.A. E.A. E108, E1285. TPC had a long history of paying substantial dividends, which TPC's management regarded as "sacrosanct" (*id.* at E1083) and planned to continue to pay. Pet. App. A37-A38; C.A. E.A. E1083, E1161. In the six years before Thompson's death, TCP paid dividends of more than $8 per share. Pet. App. A37; C.A. E.A. E203, E232, E249, E280, E313, E346, E384, E426, E471, E495. In the four years after her death, dividend payments totaled more than $4 per share. Pet. App. A37-A38.

2. On its federal estate tax return, Thompson's estate valued her shares of TPC at $1.75 million, or $3.59 per share, based on an appraisal by George E. Goerig, a tax lawyer who lived in Alaska. The estate hired Goerig to appraise the TPC stock and to represent the estate as administrator in order to shift the location of the tax audit from New York City to Anchorage, Alaska, where Goerig represented he would be able to obtain a more favorable valuation for the estate. Goerig retained, as his assistant, Paul M. Wichorek, an Alaskan accountant with limited valuation experience and no experience valuing companies involved in the Internet. Pet. App. A3,

A38-A39; C.A App. A118, A160-A161, A169-A170, A201-A202, A283-A284; C.A. E.A. E540.

Goerig's valuation was based on the capitalization of income method. He first determined TPC's average earnings for the prior five years, as reduced by an additional $10 million of technology costs above and beyond prior technology expenditures to reflect an anticipated increase in such expenses in future years; next he capitalized the earnings at a capitalization rate of 30.5% (12% of which reflected a special increase for risk presented by the Internet); and, finally, he calculated the estate's share of the resulting value and discounted it by 40% to account for the fact that the estate held a minority interest and by an additional 45% to account for the lack of marketability of the estate's shares. Goerig's valuation did not include any of TPC's "non-operating" assets, which the Commissioner's expert valued at more than $100 million. Pet. App. A4, A46-A54, A69; C.A. App. A124-A126, A614-A615.

The Commissioner valued the shares at $66.45 per share, a total of approximately $32 million, based on an appraisal prepared by Brian C. Becker, who appraised the shares using a market multiple and discounted cash flow approach. Because those methods inherently took account of the minority nature of the estate's interest, Becker did not apply a minority interest discount. In addition, Becker used only a 30% discount for lack of marketability. Pet. App. A4, A39-A40, A54-A65.

3. As relevant here, the Tax Court concluded that the estate's appraisal evidence "was to be treated as credible" (Pet. App. A46 n.6) under 26 U.S.C. 7491. That statute provides that the burden of proof on a factual issue relevant to the taxpayer's liability shifts from the taxpayer to the Commissioner if the taxpayer,

among other things, "introduces credible evidence" on the issue. 26 U.S.C. 7491(a). Accordingly, the court imposed the burden of proof on the Commissioner. Pet. App. A46 n.6.

Applying that burden of proof, the Tax Court conducted a thorough examination of the record and found that the appraisals of both the estate's experts and the Commissioner's expert were "deficient and unpersuasive." Pet. App. A65. The court noted that Goerig and Wichorek were "too inexperienced, accommodating, and biased in favor of the estate" (*id.* at A46), and the court found them "only marginally credible" and "barely qualified" to value a successful, well-established company with annual income in the millions of dollars (*id.* at A66). The court, however, agreed with Goerig's conclusion that the TPC stock should be valued using a capitalization-of-income approach, rather than the discounted cash flow approach or by comparison to the value of other companies, as proposed by the Commissioner's expert. *Id.* at A72-A73; compare *id.* at A54-A65 (describing approach of Commissioner's expert) with *id.* at A46-A54 (describing approach of estate's experts).

Accordingly, the Tax Court used the valuation proposed by the estate's experts as the starting point in determining the value of the shares. See Pet. App. A65-A77. The court then essentially made three adjustments to that valuation. First, the court determined that TPC's adjusted income should be capitalized at 18.5%, rather than 30.5%, because the record evidence did not support the 12% increase in the capitalization rate adopted by the estate's experts to reflect alleged risk posed by the Internet. *Id.* at A66-A68, A74. Second, the court determined that $68 million of non-operating assets should be included in determining TPC's overall

value. *Id.* at A69-A70, A74. Third, the court allowed only a 15% minority-interest discount and a 30% discount for lack of marketability, the percentage used by the Commissioner's expert. *Id.* at A74-A75. The court therefore valued the estate's stock in TPC at approximately $13.5 million, or $27.75 per share. *Id.* at A77.

4. The court of appeals upheld the Tax Court's valuation, except for one computational error acknowledged by both parties, and the court of appeals remanded the case for correction of that error. Pet. App. A1-A13. In so holding, the court of appeals rejected petitioners' contention that 26 U.S.C. 7491 required the Tax Court to accept the estate's valuation in full. Pet. App. A2, A6-A7.[2]

Petitioners argued that, because they had introduced some credible evidence of value, thereby shifting the burden of proof to the Commissioner, Section 7491 required the Tax Court to adopt, without any modification, the valuation proposed by the estate's experts, once the court had rejected the Commissioner's proposed valuation. See Pet. App. A2. The court of appeals held that Section 7491's allocation of the burden of proof "does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value." *Id.* at A7. Instead, the court stated, the Commissioner can satisfy his burden of disproving the taxpayer's valuation "by evidence in the

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[2] Despite their contention that the Tax Court was required to accept the valuation of the estate's expert without modification, petitioners expressly stated in their brief to the court of appeals that they were not contesting either the Tax Court's allowance of a minority interest discount of only 15%, rather than the 40% used by the estate's experts, or the court's allowance of a marketability discount of 30%, rather than the 45% used by the estate's experts. Pet. C.A. Br. 7 n.1.

record that impeaches, undermines, or indicates error in [that] valuation." *Ibid.* That conclusion, the court reasoned, is consistent with the longstanding rule that the "Tax Court is not bound by the formulas or opinions proffered by expert witnesses" but "may reach a determination of value based upon its own analysis of all the evidence in the record." *Ibid.* (quoting *Silverman* v. *Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976)).

In this case, the court of appeals observed, the Commissioner "not only presented evidence in support of his own valuation; he also cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with the company's investments in Internet-related projects." Pet. App. A7. Accordingly, after concluding that the Tax Court's factual determination of the value of the stock was not clearly erroneous, the court of appeals affirmed the Tax Court's valuation in all respects, except for the computational error noted above. *Id.* at A8.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. The petition for a writ of certiorari should therefore be denied.

1. Petitioners renew their contention (Pet. 10-16) that 26 U.S.C. 7491 required the Tax Court to accept, without modification, the stock valuation proposed by the estate's experts once the court had concluded that the Commissioner bore the burden of proof and the court had rejected the Commissioner's proposed valua-

tion. The court of appeals correctly rejected that contention.

Section 7491 provides that, when a taxpayer introduces "credible evidence" on a factual issue relating to tax liability, and certain other requirements are met, the Commissioner "shall have the burden of proof with respect to such issue." 26 U.S.C. 7491(a). As the court of appeals correctly concluded, Section 7491's reallocation of the burden of proof "does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value." Pet. App. A7. Nothing in Section 7491 alters the longstanding rule that, in determining the value of property for federal tax purposes, a court is not bound to adopt the valuation of either party's experts. See *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 295 (1938). On the contrary, the court "may reach a determination of value based upon its own analysis of all the evidence in the record." *Silverman* v. *Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976); accord, *e.g.*, *Estate of Fitts* v. *Commissioner*, 237 F.2d 729, 732-733 (8th Cir. 1956).

As the court of appeals explained, although the Commissioner bore the burden of proving that the estate's proposed valuation was too high, he did not have to satisfy his burden by proving that his own expert's valuation was correct; instead, he could satisfy his burden "by evidence in the record that impeache[d], undermine[d] or indicate[d] error in the taxpayer's valuation." Pet. App. A7. That conclusion accords with the general rule that, "[i]n determining whether any fact has been proved," the fact-finder must "consider all of the evidence bearing on the question regardless of who introduced it." 7th Cir. Fed. Civil Jury Instruction 1.08; see,

e.g., *Fidelity & Cas. Co.* v. *Driver*, 79 F.2d 713, 714 (5th Cir. 1935). It also accords with the traditional rule in tax valuation cases that "[t]he fair market value of property * * * is a question of fact for the tax court to resolve considering *all* relevant evidence in the record." *Orth* v. *Commissioner*, 813 F.2d 837, 842 (7th Cir. 1987) (emphasis added); see *Silverman*, 538 F.2d at 933 (court's determination should be based on "*all* the evidence in the record") (emphasis added); 26 C.F.R. 20.2031-2(f) ("fair market value" depends on the "facts of each case"); Rev. Rul. 59-60, 1959-1 C.B. 237, 238 ("A sound valuation will be based upon all the relevant facts.").

As the court of appeals observed, the Commissioner "cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with [TPC's] investments in Internet-related projects." Pet. App. A7. In light of that evidence and argument, the Tax Court correctly concluded that the Commissioner had proved that the valuation proposed by the estate's experts was "deficient and unpersuasive" in several critical respects. *Id.* at A65.

The Tax Court found essentially three errors in the estate's experts' valuation: first, the estate's experts had incorrectly added 12 percentage points to the rate used to capitalize TPC's income to reflect the risk posed by the Internet; second, they had incorrectly failed to include $68 million of non-operating assets in determining TPC's value; and, third, they had incorrectly applied a 40% minority-interest discount and a 45% lack-of-marketability discount. Pet. App. A65-A77. Contrary to pe-

titioners' suggestions that there was no record evidence to support those findings, there was ample evidence, including evidence introduced by the Commissioner.

As the Tax Court explained, its rejection of the 12 percentage point adjustment for Internet risk was supported by extensive evidence showing that, "while the Internet posed certain risks to TPC, the Internet also provided significant new business and financial opportunities." Pet. App. A66. Indeed, at the time of Thompson's death, "TPC appeared to be well situated on the Internet, and TPC's future as to its Internet operations appeared good." *Id.* at A66-A67. That view was repeatedly stated by TPC's management and supported by the testimony of the Commissioner's expert. See *id.* at A24, A66-A67; C.A. E.A. E648, E1087, E1212. It was also supported by TPC's operating results in the years preceding Thompson's death, during which subscriptions to TPC's electronic products and TPC's advertising revenues from those products both increased substantially. See Pet. App. A25-A27; C.A. E.A. E370, E407, E451, E519, E917-E918, E925.

The Tax Court's decision to reduce the capitalization rate was also supported by TPC's long history of paying substantial cash dividends, which the evidence showed was likely to continue. See Pet. App. A37-A38, A67; C.A. E.A. E1083, E1161. Indeed, in the six years preceding Thompson's death, TPC paid dividends per share equal to twice the per-share valuation proposed by the estate's experts. And, in the four years after Thompson's death, TPC again paid dividends per share that exceeded the per-share valuation. See Pet. App. A37-A38; C.A. E.A. E203,E232, E249, E280, E313, E346, E384, E426, E471, E495. Thus, the Tax Court was amply justified in concluding that the capitalization rate used by the estate's

experts was excessive and reflected their bias and lack of experience in evaluating the effect of the Internet and other technologies on the value of a company. Pet. App. A46, A47, A66; see C.A. App. A169-A170, A201-A202.

The Tax Court's decision to include $68 million in non-operating assets in TPC's valuation was also well supported by the evidence, including the testimony of the Commissioner's expert. He testified that TPC's non-operating assets, *i.e.*, those that TPC was not using to finance its "day-to-day operations," amounted to over $100 million, including cash-on-hand and short-term investments. C.A. App. A614-A615. The Tax Court included only the $68 million in short-term investments, agreeing with petitioners that TPC's cash-on-hand should be treated as an operating asset because it was needed to run the business. Pet. App. A69-A70. That was an extremely conservative estimate of TPC's non-operating assets, amounting to only 37% of TPC's current assets. See C.A. E.A. A108, A1285.

The Tax Court's rejection of the 40% minority interest discount and 45% discount for lack of marketability used by the estate's experts was also well grounded in the evidence. As the court explained, "[t]he experts for the estate selected discount rates that were extreme and highly favorable for the estate, without any credible substantive discussion of how the facts of this case support[ed] such particular discounts." Pet. App. A70. The Tax Court settled on a 20% minority-interest discount based on a review of the discounts used in other cases and an analysis of the estate's particular minority interest. See *id.* at A73-A75. After a similarly careful analysis of the facts, the court agreed with the Commissioner's expert that the discount for lack of marketability should be no higher than 30%. See *id.* at A75. In

their opening brief in the court of appeals, petitioners essentially conceded that the Tax Court was justified in rejecting their proposed discounts, stating that "[t]he Estate is not seeking review of those findings." Pet. C.A. Br. 7 n.1. In light of that concession, petitioners' contention that the Tax Court was nonetheless required by Section 7491 to accept their experts' valuation without any modification is simply untenable.

2. Petitioners also err in contending (Pet. 16-19) that the decision below conflicts with decisions of other courts of appeals. Indeed, none of the cases cited by petitioners even addressed whether Section 7491 requires a court to accept the taxpayer's valuation when the court concludes that the Commissioner bears the burden of proof and the court rejects the Commissioner's valuation.

Caracci v. *Commissioner*, 456 F.3d 444 (5th Cir. 2006), did not involve Section 7491 at all. Instead, *Caracci* involved the entirely different rule, based on case law, that the Commissioner bears the burden of proving a taxpayer's actual tax liability once the taxpayer has established that the original assessment was arbitrary and erroneous. See *id.* at 457. In *Caracci*, the court of appeals held that the Tax Court committed error because it "did not place the burden of proof on the Commissioner" but instead expressly declined to decide which party had the burden. *Ibid.* Here, in contrast, the Tax Court expressly placed the burden of proof on the Commissioner. Pet. App. A46 n.6. Moreover, in *Caracci*, the court of appeals rendered judgment for the taxpayer because the court concluded that "the record [made] it clear that the Commissioner [could not] meet his burden of proof." 456 F.3d at 462. In contrast, in this case, as the court below held, the Tax Court cor-

rectly found, based on all the evidence in the record, that the Commissioner proved that the estate's stock had a value of $13.5 million, based on the valuation methodology used by the estate's experts, as corrected to eliminate the effect of the experts' errors, bias, and inexperience.

Griffin v. *Commissioner*, 315 F.3d 1017 (8th Cir. 2003) (per curiam), involved Section 7491, but the court of appeals did not address whether the Tax Court must accept the taxpayer's valuation without modification if the court concludes that the Commissioner has the burden of proof and the court rejects the Commissioner's valuation. *Griffin* held only that, under the facts of that case, the taxpayers had introduced sufficient "credible evidence" to shift the burden of proof. *Id.* at 1022. To the extent that *Griffin* is relevant to the question decided by the court below, *Griffin* supports the court's decision. The court in *Griffin* emphasized that the determination whether a taxpayer had provided "credible evidence" should be made as "*if no contrary evidence were submitted.*" *Id.* at 1021. And, upon concluding that the taxpayers had presented credible evidence, the court of appeals remanded the case for the Tax Court to determine, based on "all of the evidence properly before it," "whether the Commissioner has met his burden of proof." *Id.* at 1022.

Morrissey v. *Commissioner*, 243 F.3d 1145 (9th Cir. 2001), and *Estate of Simplot* v. *Commissioner*, 249 F.3d 1191 (9th Cir. 2001), have virtually nothing to do with the issue presented in this case. In *Morrissey*, the court of appeals held that, on the evidence presented, actual arm's length sales of stock were more persuasive evidence of value than the Commissioner's estimate of the stock's value. 243 F.3d at 1147-1148. In *Estate of Sim-*

plot, the court of appeals rejected the Tax Court's conclusion, on the facts of the particular case, that the value of an estate's minority stock interest should be increased to reflect its supposed voting power. 249 F.3d at 1195-1196. The court of appeals did not cite Section 7491 in either case, much less address the issue decided by the court below.

JPMorgan Chase & Co. v. *Commissioner*, 458 F.3d 564 (7th Cir. 2006) (*JPMorgan*), also did not involve Section 7491. Instead, *JPMorgan* turned on a different statute, 26 U.S.C. 446, which prescribes the method of accounting for taxable income. Section 446 provides that taxable income shall be computed using the method of accounting that the taxpayer regularly uses to keep his books, but, if that method does not "clearly reflect income, then the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner,] does clearly reflect income." 26 U.S.C. 446(b). The court of appeals held that, once the Tax Court determined that the taxpayer's method of accounting for interest swaps did not clearly reflect income, Section 446(b) required the Tax Court to use the method proposed by the Commissioner unless that method was "clearly unlawful" or "plainly arbitrary." *JPMorgan*, 458 F.3d at 570 (citation omitted). The court of appeals' interpretation of Section 446 has little, if any, bearing on how to interpret the entirely different statute at issue in this case.[3]

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[3] Petitioners also mistakenly contend (Pet. 20-22) that this Court should grant the petition for a writ of certiorari to resolve a conflict between the decision of the court below and two Tax Court decisions, *Kohler* v. *Commissioner*, 92 T.C.M. (CCH) 48 (2006), nonaq., 2008-9 I.R.B. 482, and *Forste* v. *Commissioner*, 85 T.C.M. (CCH) 1146 (2003). A purported conflict between the decision of a court of appeals and trial

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

PAUL D. CLEMENT
Solicitor General
NATHAN J. HOCHMAN
Assistant Attorney General
RICHARD FARBER
STEVEN W. PARKS
Attorneys

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court decisions is not a basis for review by this Court. See Sup. Ct. R. 10. In any event, neither *Kohler* nor *Forste* applied a rule that, whenever the Tax Court concludes that the Commissioner bears the burden of proof on valuation of property under Section 7491, the court must accept the taxpayer's valuation, however erroneous, once the court has rejected the valuation proposed by the Commissioner. In *Kohler*, for example, the Tax Court carefully scrutinized the valuation of the taxpayer's experts, whom it found "thoughtful and credible." 92 T.C.M. (CCH) at 56. The court accepted the taxpayer's proposed valuation only "[a]fter carefully reviewing and considering *all* of the evidence." *Ibid.* (emphasis added).